In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 283

THE HERTZ CORPORATION, a corporation (SUCCESSOR BY MERGER TO J. FRANK CONNOR, INC., a corporation),

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered in the above-entitled case on July 6, 1959.

OPINIONS BELOW.

The opinion of the District Court for the District of Delaware is reported at 165 F. Supp. 261, and is also set forth in the record, pages 22a-52a. The opinion of the Court of Appeals (Appendix A, *infra,* pp. 21-30) is unofficially reported at 59-2 USTC Para. 9560.

JURISDICTION.

The judgment of the Court of Appeals was entered on July 6, 1959. (Appendix A, *infra,* p. 30.) The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

QUESTION PRESENTED.

Petitioner taxpayer is in the business of renting and leasing automobiles and trucks, which it owns for varying periods. Under Section 167(c) of the 1954 Internal Revenue Code, certain accelerated depreciation methods (including the declining balance method under Section 167(b)(2)) may be used only with respect to property "with a useful life of 3 years or more. . . ."

The question presented is whether petitioner, for its taxable years 1954, 1955, and 1956, can compute its depreciation allowance by using the accelerated declining balance method authorized by Section 167(b)(2) on the basis that "useful life" means the physical or inherent functional life of petitioner's vehicles (*i.e.*, their life for general business purposes), as petitioner contends, rather than the period of their usefulness to petitioner in its particular business, as the court below held, and on the basis that the only salvage value limitation in the use of that method is the salvage value which is inherent in that method, as petitioner contends, rather than a salvage value which the regulations purport to define as the estimated resale value of petitioner's vehicles at the end of their useful life in its particular business, as the court below held.

STATUTES AND REGULATIONS INVOLVED.

Subsections (a), (b), (c) and (f) of Section 167 of the 1954 Code and the pertinent sections of the Treasury Regulations promulgated thereunder, together with Sections 1011, 1012, 1016 and 1231 of that Code, are set forth in Appendix B, *infra*, pp. 31-38. Section 117 (j) of the Internal Revenue Code of 1939 is set forth in Appendix B, *infra*, p. 34.

STATEMENT.

(1) The facts.

The facts, as found by both courts below (R. 23a-31a; Appendix A, *infra*, pp. 22-24), may be summarized as follows:

During the taxable years involved (fiscal years ended March 31, 1954, 1955 and 1956), taxpayer engaged in the business of renting and leasing automobiles and trucks without drivers. "Renting" is the hiring of vehicles on a short-term basis at stipulated rates per mile, per hour, or per day. "Leasing" is the contract hiring of vehicles on a relatively long-term basis, such as for a year or longer. (R. 17a, 23a, 43b; Appendix A, *infra*, p. 22.)

Among the factors which influenced petitioner's decision to buy and sell automobiles were the percentage of its fleet being operated regularly; the activities of its competitors; mechanical changes; strikes and lockouts; climatic conditions; whether the country was at war or at peace; the ability to obtain new cars; economic conditions in its business area; and its financial situation. (R. 23a-26a, 43b-48b; Appendix A, *infra*, p. 23.)

None of these factors was predictable in advance. (R. 26a, 49b; Appendix A, *infra*, p. 23.)

Under the influence of these factors, the periods during which petitioner used automobiles and trucks in its renting and leasing business varied considerably not only during the taxable years but throughout petitioner's business history. The average holding period of automobiles sold during the taxable years was 26.17 months. The average holding period of automobiles sold during the entire nine year period of petitioner's operation was 29.36 months. In 1954 cars were held for as long as 67 months, and in 1956 for as long as 51 months; in prior years cars were held for as long as 81 months. The average holding period

of trucks sold during the taxable years was 38.89 months. The average holding period for such trucks during the entire nine-year period was 48.26 months. (R. 22a, 27a; Appendix A, *infra*, p. 23.)

Certified public accountants, partners in the firms of Ernst & Ernst, Price Waterhouse & Company, and Arthur Andersen & Co., testified without contradiction that the term "useful life" has always meant the economic or business life of the asset in whatever hands, and not the taxpayer's holding period; that the "useful life" of automobiles used for business purposes is four years; that over the years the term "useful life" in business and accounting has come to be regarded as the business life of an asset whether or not it passed from one owner to another, *i.e.*, the total period for which the asset was useful for business purposes; that this was not only the general accounting understanding of the term, but that, prior to the promulgation of the Treasury's 1956 regulations on depreciation their experience with Internal Revenue Service representatives was always that the depreciation rate was computed on the basis of the aggregate business life of the asset regardless of changes in ownership. (R. 27a, 29a-30a, 39a, 31b-34b, 35b-41b; Appendix A, *infra*, p. 23.)

In its income tax returns for the years ended March 31, 1954, 1955 and 1956, petitioner claimed depreciation on automobiles on the basis of a four-year life, at a rate of 30% for each of the first two years and 20% for each of the last two years, and on trucks at a uniform rate on the basis of a five-year life for heavy duty trucks and a four-year life for other trucks. The return for the taxable year ended March 31, 1955 was examined by the Internal Revenue Service and approved as filed except for a minor adjustment not here relevant. (R. 21b, 30b, 56b-57b; Appendix A, *infra*, pp. 23-24.)

Petitioner duly filed claims for refund of income taxes paid for the three years mentioned, electing to use declining balance depreciation on its automobiles and trucks, using 200% of the straight-line rate, in lieu of the straight-line deductions claimed on the original tax returns. The Commissioner of Internal Revenue took no action on these claims for six months, and this suit for refund followed. (R. 3a-13a, 17a; Appendix A, *infra*, p. 24.)

(2) Decisions of the courts below.

The District Court rendered judgment for petitioner, holding that in 1954, and for many years before, the term "useful life" had come to mean the entire physical life of the asset for business purposes, but that Congress, in enacting the 1954 Code, intended to change that meaning; that "useful life," as used in that Code, now means the useful life of an asset in the hands of the particular taxpayer; that Reg. Sec. 1.167(a)-1(b) of the Treasury Regulations, defining the term "useful life" to mean the period over which the asset may reasonably be expected to be useful to the taxpayer, was valid; that the Commissioner, before issuing the depreciation regulations of 1956, had apparently acquiesced in the construction of the term "useful life" as used in business and accounting circles, to mean the physical business life of the asset; that the regulations could not be applied retroactively to the three taxable years here involved; and that, therefore, petitioner, whose automobiles, during the period under review, had been held for average periods of less than three years, was entitled to claim depreciation under the declining balance method. (R. 39a, 49a-50a).

Respondent conceded in the District Court that even under the definition of "useful life" contained in the 1956 regulations, petitioner's trucks had a life of more than

three years, and that petitioner was entitled to use declining balance depreciation on those items. Respondent contended, however, that under Reg. Sec. 1.167(a)-1 (a) and (c) and 1.167(b)-2 (a) of the regulations these trucks could not be depreciated below an imposed salvage value. The District Court disagreed, holding that salvage value is inherent in the declining balance method of depreciation and that the legislative history of the depreciation provisions of the 1954 Code demonstrated that salvage value was not to be considered in computing depreciation under the declining balance method. (R. 47a-49a.)

The Court of Appeals for the Third Circuit reversed the District Court's judgment, holding (a) that "useful life" for depreciation purposes, as used under the 1939 Code and in Section 167 of the 1954 Code, means the period during which property is useful to the particular taxpayer, and not the physical or economic life of the property, and (b) that salvage value (other than that inherent in the method) is a limitation on depreciation under the declining balance method provided for in Section 167(b)(2) of the 1954 Code. (Appendix A, *infra*, pp. 29, 30.)

REASONS FOR GRANTING THE WRIT.

(1) The Conflict: The decision below, involving fundamental questions of interpretation of the terms "useful life" and "salvage value" in computing the depreciation deduction authorized by Section 167 of the 1954 Internal Revenue Code (Appendix B, *infra*, pp. 31-32), is in direct conflict with the decision of the Court of Appeals for the Ninth Circuit in *Evans* v. *Commissioner of Internal Revenue*, 264 F. 2d 504 (opinion reprinted in Appendix C, *infra*, pp. 39-62), in which the Commissioner has filed a petition

for certiorari now pending as No. 143, this Term, which petition the taxpayer in that case is not opposing. As that petition concedes (p. 13), " . . . the same basic issue presented here [in *Evans*] as to useful life and salvage value is presented, under the 1954 Code, in *Hertz* [this case]."[1]

The court below recognized the conflict with *Evans* (Appendix A, *infra*, p. 27). And the United States has since conceded that on the basic issue presented there is "now a clear and acknowledged conflict" between *Evans* and the decision of the Third Circuit in the instant case. (See Memorandum for the United States in response to the pending petition in *Massey Motors, Inc.* v. *United States*, No. 141, this Term.)[2]

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[1] The question of salvage value arises in a slightly different way in the two cases, but, as the Commissioner's petition in *Evans* explicitly recognizes, that does not alter the situation. In *Evans*, the question of salvage value arises under the straight-line method of depreciation, with the Commissioner contending that salvage value means "the estimated resale value of the cars at the end of . . . their useful life in the taxpayer's business", (petition in *Evans*, pp. 2, 8-9), rather than their value at the end of their physical useful life, as the Ninth Circuit held. In the instant case, the question of salvage value arises under the declining balance method of depreciation, with the petitioner contending that it is to be limited only by the salvage value which is inherent in that method, while the United States contends and the court below held that depreciation under the declining balance method cannot be taken below a reasonable salvage value, which the regulations purport to define as the amount which it "is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business" (Reg. Sec. 1.167(a)-1 (c)). Thus, the position of the tax authorities on the issue of salvage value is precisely the same in both cases—that salvage value in each case is tied and limited to "useful life" in the taxpayer's business and that the taxpayer cannot take depreciation below the estimated resale value of the cars at the end of their useful life in his particular business.

[2] The United States also asserts that there is a clear conflict between *Evans* and *Massey*. However, petitioner believes that the facts in *Massey* are significantly different from those in *Evans* and the instant case.

We believe the decision below to be erroneous, and shall demonstrate the clear conflict with the decision of the Ninth Circuit Court of Appeals in the *Evans* case, *supra*, which we submit is correct.

~~Eligibility for accelerated~~ depreciation under Subsections 167(b) and (c) of the 1954 Internal Revenue Code is restricted to property with a "useful life of 3 years or more." A critical question, therefore, is the meaning of "useful life." The court below and the parties agree that the 1954 Code did not change (and was not intended by Congress to change) the meaning of that term as it was understood at the time of enactment of the 1954 Code. The court below was of the opinion that "useful life" has always meant the period of usefulness of the asset to the particular taxpayer in his business.

This view is contrary to the holding in *Evans*, *supra*, and is contrary to the consistently applied meaning of the term at the time of enactment of the 1954 Code. That meaning, as established by judicial interpretation, administrative practices and pronouncements under the 1939 Code and prior revenue acts, and expert opinion is: the physical or inherent functional life of the property (*i.e.*, the life of the property for general business purposes) and not the period during which it is estimated the taxpayer may hold the property.

(a) The cases.

The decided cases have long recognized that "useful life" means the business life of the asset itself, and not the holding periods of specific taxpayers.[3]

While the Third Circuit viewed these cases as of minor importance (Appendix A, *infra*, p. 27), the Ninth Circuit in the *Evans* case said with respect to the same cases:

> "Further evidence of the position of the Commissioner is drawn from his acquiescence in decisions of the Board of Tax Appeals which measured 'useful life' of the depreciable asset not by the holding period

[3] Among these cases are: *Sanford Cotton Mills*, 14 B.T.A. 1210 (1929), Acq. X-2 CB 63; *Merkle Broom Co.*, 3 B.T.A. 1084 (1926), Acq. V-2 CB 2; *Max Kurtz, et al.*, 8 B.T.A. 679 (1927), Acq. VII-1 CB 18; *General Securities Co.*, B.T.A. Memo., CCH Dec. 12,500-D (1942), aff'd 137 F. 2d 201 (6th Cir. 1943); *West Virginia & Pennsylvania Coal & Coke Co.*, 1 B.T.A. 790 (1925); *J. R. James*, 2 B.T.A. 1071 (1925), Acq. V-1 CB 3; *Wallace G. Kay*, 10 B.T.A. 534 (1928), Acq. VII-1 CB 17; *W. N. Foster, et al.*, 2 TCM 595 (1943); *John A. Maguire Estate, Ltd.*, 17 B.T.A. 394 (1929), Acq. IX-1 CB 34; *Nat Lewis*, 13 TCM 1167 (1954); *Whitman-Douglas Co.*, 8 B.T.A. 694 (1927); *Pilot Freight Carriers, Inc.*, 15 TCM 1027 (1956). These square holdings in support of petitioner's position on the meaning of "useful life" (in no fewer than six of which the Commissioner officially acquiesced) were dismissed by the court below as of little value as precedents (Appendix A, *infra*, p. 27.) However, in response to those holdings neither the court below nor the respondent has offered a single citation of any case or ruling decided or published before the enactment of Section 167 in which the government even contended (much less established) that useful life meant a taxpayer's holding period. With respect to the quotation from *United States v. Ludey*, 274 U.S. 295, 300-01 (1927), relied upon by the court below (Appendix A, *infra*, p. 25), the Ninth Circuit stated in *Evans* (264 F. 2d at 514; Appendix C, *infra*, p. 61):

> "The Commissioner contends that to define 'useful life' as the physical or economic life of a depreciable asset . . . is contrary to the theory underlying such allowance . . . citing *United States v. Ludey*, 274 U.S. 295 . . .
>
> "Again, the Commissioner overlooks the force of his own regulations, his long-continued, consistent practice thereunder, and the Congressional intent expressed in the enactment and subsequent legislative history of Section 117(j)."

> of such asset by the particular taxpayer, but by the economic or physical life of such asset." (264 F. 2d at 509; Appendix C, *infra*, p. 50.)

And, indeed, the Ninth Circuit went on to discuss in detail the facts and holdings in two of the cited cases.

(b) The Commissioner's own pronouncements.

Until some time after Congress enacted the 1954 Code, the Commissioner of Internal Revenue himself consistently supported and urged as the definition of "useful life" the physical or inherent functional life of the property, and not the taxpayer's holding period.[4]

The Third Circuit dismissed these rulings summarily by simply stating that they were ambiguous (Appendix A, *infra*, p. 27). But the Ninth Circuit found clear indication in those rulings of the meaning of "useful life," saying:

> "Our attention has been directed to certain pronouncements of the Commissioner dealing with the general subject under review. In each of such pronouncements, it is evident that the Commissioner's concept of the term "useful life" was not measured by the period in which the depreciable asset was useful in the taxpayer's business, but was measured rather by the economic or physical life of the depreciable asset." (264 F. 2d at 509; Appendix C, *infra*, p. 50.)

Further, the opinion of the Third Circuit quotes excerpts from Bulletin "F" in support of its conclusion (Appendix A, *infra*, pp. 27-28). The Ninth Circuit, in a more detailed review of Bulletin "F", said:

> "The recommended useful life on motors and other vehicles appears on page 52. Therein it is stated,

[4] O. D. 845, CB June, 1921, page 178; Rev. Rul. 108, 1953-1 CB 185; Rev. Rul. 54-229, 1954-1 CB 124. Indeed, Rev. Rul. 54-229 was issued *after* the Senate Finance Committee revealed its determination to limit accelerated depreciation by a "useful life" test

'Motor vehicles included in this classification are those used by commercial enterprises other than public utility and construction.

Lives considered reasonable are indicated below:

Automobiles:	Years
Passenger	5
Salesman	3 ' "

"In the instant case, as noted above, the petitioner used a useful life of four years in his depreciation schedules.

"While we recognize that Bulletin 'F' does not have the force of law, we do believe that a fair construction of the pertinent provisions of such Bulletin, aided by the practice of the Commissioner, reasonably indicates that *the Commissioner did not consider as a factor in determining depreciation the expected or intended disposal plans of the taxpayer with respect to property used in his trade or business, nor did the Commissioner consider that the useful life of an asset was to be measured by the estimated holding period of such asset by the taxpayer.*" (264 F. 2d at 510; Appendix C, *infra*, pp. 53-54; emphasis added.)

The depreciation regulations under Section 167 originally proposed (Federal Register, September 28, 1954, Volume 19, Number 188, pages 6229-6234) are far closer to the "substantially contemporaneous [administrative] opinion" referred to in *White* v. *Winchester Country Club*, 315 U.S. 32, 41 (1942), than the 1956 regulations, which were proposed more than a year after that enactment and were not finally promulgated until almost two years after passage of the 1954 Code.

Finally, in a number of briefs filed by the Commissioner, he has also urged the definition of "useful life" which petitioner submits is correct. For example, in *Penn* v. *Commissioner of Internal Revenue*, 199 F. 2d 210 (8th

Cir. 1952), at pages 10-11 of the Commissioner's brief, he refutes the very argument which respondent makes in the instant case:

> "The basic fallacy in taxpayer's argument lies in her assumption that 'depreciation' has reference to the life of the owner of property, rather than to *the life of the property itself. . . . The wear and tear of 'property' has no relation to the life expectancy of its owner. On taxpayer's theory, every owner of a depreciable interest in property would be entitled to deduct annual depreciation at a rate based on the number of years he expects to live and enjoy the income from the property, instead of the number of years the property may be expected to produce income, a result repugnant to the fundamental concepts of depreciation.*" (Emphasis added.)

(c) Expert testimony.

With respect to the testimony of petitioner's expert witnesses, the District Court below stated:

> "I accept the testimony of accountants from nationally recognized firms that by 1954, the phrase 'useful life' was taken in business and accounting circles to mean the whole physical life of the asset and that the useful life of an automobile used in a business was four years. Their testimony was virtually unchallenged on cross-examination and the Commissioner offered no testimony in his own behalf." (R. 39a.)

The Third Circuit adopted instead (Appendix A, *infra*, p. 28) a statement in a textbook (written, it should be noted, while the instant case was pending) whose authors were, of course, not subject to cross-examination at the trial and whose declaration that useful life "has been construed and applied as meaning the useful life to the taxpayer, not to taxpayers generally . . . ."[5] cites no authority whatever in its support.

[5] Montgomery's Federal Taxes (37th Edition, 1958), page 65.

The Ninth Circuit, on the other hand, gave weight to such testimony given by two certified public accountants at the trial in the Tax Court, saying:

> "The long-continued and consistent practice and position of the Commissioner in measuring useful life by the physical or economic life of the depreciable asset were reflected in testimony before the Tax Court. . . . " (264 F. 2d at 511; Appendix C, *infra*, pp. 55-56.)

(d) Legislative history of Section 167 of the 1954 Code.

In its analysis of the statutes and regulations, the Ninth Circuit in *Evans* found that the law on useful life, as it stood when Congress proceeded to consider the drafting and adoption of the 1954 Code, consisted of the following:

> (i) A basic depreciation statute re-enacted many times, substantially unchanged, in successive revenue acts over a period of more than 40 years, in the light of, and without any attempt to change
>
> (ii) the Commissioner's basic depreciation regulations, which had been long continued in virtually identical form since 1918,[6]

and on the basis of its review of the cases and the Commissioner's own pronouncements it concluded that they were consistently interpreted by the courts, and by the Commissioner himself, as applying and defining useful life as the life of an asset for general business purposes and not the period during which it happens to be held by a particular taxpayer.

[6] See the analysis of depreciation regulations in *Evans* v. *Commissioner of Internal Revenue*, 264 F. 2d 502, 507-8 (Appendix C, *infra*, pp. 47-49). The Third Circuit's statement (Appendix A, *infra*, p. 29) that petitioner "relied upon" a 1942 change in the regulations is incorrect. There was no such reliance or argument by petitioner; a discussion of the change appears in *Evans*, at Appendix C, *infra*, pp. 48-49.

On the other hand, the Third Circuit, in its opinion below, without any similar detailed discussion of prior statutory or regulatory provisions, simply concluded that the regulations issued by the Commissioner implemented the statutory scheme with respect to depreciation.

In the 1954 Code, Congress used the phrase "useful life" in the depreciation statute for the first time. If some meaning other than its traditionally accepted meaning had been intended, Congress would certainly have added a qualification of its own, such as the words "until sold or otherwise disposed of by the taxpayer"—or some other such explanatory phrase. No such qualification was added.

The committee reports,[7] hearings and Congressional debates on H.R. 8300, 83rd Cong., 2d Sess. (which ultimately became the 1954 Code) show that "useful life" was being used, in accordance with pre-existing law, as general life for business purposes, not the taxpayer's holding period. (House Report, pages 23, A48; Senate Report, pages 27, 201; statement of Senator Bennett;[8] statement of Undersecretary of the Treasury Marion B. Folsom;[9] debate on Senate floor, July 2, 1954, 100 Cong. Rec. [Part 7] 9599-9600, 83rd Cong., 2d Sess.)

Indeed, the very theory and language of the holding period concept of useful life was before Congress during the same session at which the 1954 Code was drafted, considered and enacted, but that theory and language were not adopted. On January 14, 1954 there was introduced and referred to the House Ways and Means Com-

[7] House Report No. 1337, 83rd Cong., 2d Sess.; Senate Report No. 1622, 83rd Cong., 2d Sess. (hereinafter called the "House Report" and "Senate Report," respectively).

[8] Hearings before the Committee on Finance, United States Senate, 83rd Cong., 2d Sess., on H.R. 8300, Part 1, page 137.

[9] *Ibid.*, page 118.

mittee H.R. 7173, which distinguished useful life from holding period. This measure would have permitted taxpayers to determine their own depreciation rates, subject to the limitation that not more than 50% of the basis of property could be deducted in the year of acquisition—but at the price of treating gain resulting from the accelerated reduction of basis as ordinary income and not capital gain,[10] except in the case of property "held" for more than five years. But Congress did not adopt H.R. 7173.

(e) Salvage value as a limitation on declining balance depreciation.

The Treasury Department's regulations under the 1954 Code (Reg. Sec. 1.167 (a)-1(a), 1.167 (a)-1(b) and 1.167 (b)-2(a)) seek to impose a dollar limit at which the taking of depreciation under the declining balance method must stop. The Third Circuit opinion, while purporting to base its approval of the cited regulations on a study of the legislative history of the 1954 Code (Appendix A, *infra*, pp. 29-30), ignores, among other things:

(i) the Senate Finance Committee's instruction (page 201 of the Senate Report) that:

> "The salvage value is not deducted from the basis prior to applying the rate, since under this method [the declining balance method] at the expiration of useful life there remains an undepreciated balance *which represents salvage value.*" (Emphasis added):

[10] This method of dealing with rapid depreciation is exactly the method which Congress had enacted with respect to the amortization of emergency facilities in Sections 124A and 117 (g) (3) of the 1939 Code, and which it was to reaffirm in Sections 168 and 1238 of the 1954 Code. Significantly, with H.R. 7173 before it, Congress did not see fit to enact a like limitation in connection with the sale of depreciable property generally.

(ii) the Committee's explanation of the 3-year useful life limit (page 29 of the Senate Report) in terms of pointing out that in the case of an asset with a 2-year life, doubling the 50% straight-line rate would be equivalent to expensing the cost in the year of acquisition;[13] and

(iii) Recommendation No. 20 of the Committee on Federal Taxation of the American Institute of Accountants, filed with the Senate Finance Committee, on April 19, 1954:[14]

> "20. Section 167 (b)(2): Attention is called to the fact that *by reason of the elimination of the factor of salvage value in the computation of the declining balance method*, the resulting initial amount of depreciation may be considerably more than twice what is allowed under the straight-line method." (Emphasis added.)

The District Court below correctly held (R. 47a-49a) that salvage value (other than that inherent in the method) is not a limitation on declining balance depreciation under Section 167 (b)(2) of the 1954 Code.

(f) Retroactive applicability of 1956 regulations.

Petitioner does not dispute the Commissioner's power to interpret the statutory provisions of the Internal Revenue Code by regulations which are within the bounds set by Congress. We believe that the courts' and the Commissioner's long-standing definition of "useful life" was the physical or inherent functional life of the property,

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[13] This, of course, could not be so if the Committee contemplated that salvage value should represent a limitation on depreciation under the declining balance method.

[14] Hearings before the Committee on Finance, United States Senate, 83rd Cong., 2d Sess., on H.R. 8300, Part 3, page 1314.

and that that definition was adopted by Congress not only through repeated re-enactment of the basic depreciation statute since 1913, but by the re-enactment in 1954 (which took into the statute the very words—"useful life"—which had been in the Commissioner's regulations for many years). *Cammarano* v. *United States*, 358 U.S. 498 (1959). But even if it were assumed (though not conceded) that the 1956 regulations were not invalid in attempting to change the meaning which had theretofore been established, the Commissioner's definition of "useful life" in the 1956 regulations—to the extent that he may validly interpret the statute in this regard—may not be applied to periods before the date of promulgation of such regulations. *Helvering* v. *Griffiths*, 318 U.S. 371, 395 (1943); *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110, 116 (1939); and *Aluminum Co. of America* v. *United States*, 123 F. 2d 615, 620-21 (3rd Cir. 1941).

The square conflict between these two circuits may best be summed up by the conclusory statements in their respective opinions. The Third Circuit concluded as follows:

> "We are of the opinion that the accepted meaning of the term "useful life" has *always* been the period of usefulness of the asset to the taxpayer in his business . . . ." (Emphasis added.) (Appendix A, *infra*, p. 2.)

On the other hand, the Ninth Circuit concluded:

> "In light of the language of [Regulation] Section 29.23 (l), the consistent practice and position of the Commissioner over many years, the interpretation placed on the term 'useful life' by decisions of the Tax Court extending over a long period, we hold that under the Internal Revenue Code of 1939 the Tax Court erred when it measured useful life of the de-

preciable assets involved here by the period during which such assets were held in the business of petitioner instead of the physical or economic life of such assets." (264 F. 2d at 512; Appendix C, *infra*, p. 56.)

This view has recently been followed in *Charlie Hillard*, 31 TC 961, decided February 9, 1959 (now on appeal to the Fifth Circuit), where the taxpayer was also in the car rental business. Regarding depreciation allowable for periods during which taxpayer's automobiles were held for rental purposes, Judge Raum stated:

> "Petitioner, in his returns, originally treated the rental cars as having a normal useful life of *three years;* and the Commissioner's determination, agreed to by petitioner, fixed that period at *four years. Yet, it was petitioner's practice to sell the cars after they had been in use for only about a year.* Thus, when he purchased the cars in the first instance it was plainly his intention to use them in the rent-a-car operation *for a comparatively minor portion of their useful life and then to sell them.*" (31 TC at 969; emphasis added.)

(2) Importance of the Issues Involved: As the Commissioner states in his petition in *Evans*, the basic issue as to useful life and salvage value, which is presented there and in this case, is of substantial and continuing importance.

In his *Evans* petition (p. 11, footnote 7), the Commissioner illustrates this point by calling this Court's attention to the capital gains provision under Section 117(j) of the 1939 Code (Section 1231 of the 1954 Code). Since 1942, Congress has provided for capital gains treatment of profits resulting from the sale of depreciable business property held for more than six months (Section 117(j), 1939 Code; Section 1231, 1954 Code). The Treasury Department's

persistent attempts[11] to eliminate these relief provisions, which attempts petitioner described and argued at length below, are not mentioned in the Third Circuit opinion. Indeed, neither Section 117(j) nor Section 1231 is mentioned therein. Having failed in his frontal attacks on these provisions, the Commissioner has tried to achieve the desired results by obliquely shifting his attack to the depreciation allowance itself. In capitulating to that attack, the court below ignores—and thereby frustrates—Congress's avowed intention[12] to stimulate capital investment by liberalizing the tax benefits derived from depreciation.

The Internal Revenue Service has estimated "that there are now pending 503 cases involving more than $16,000,000, which raise the issue under either the 1939 or 1954 Code" (petition in *Evans*, pp. 13-14). *Evans*, and also *Massey*, involve the 1939 Code. The instant case is the only one now before this Court which presents the basic issue under the current 1954 Code. While the parties have agreed and the court below has held that the 1954 Code did not make any change in the concept of useful life, resolution of the issue in terms of the 1939 Code will still leave open the question of the proper interpretation of the 1954 Code

[11] See "Revenue Revisions, 1947-1948," hearings of December 2-12, 1947, Part 5, page 3756; Statement of Secretary of the Treasury Snyder to the House Ways and Means Committee, February 3, 1950, Hearings before the Committee on Ways and Means, House of Representatives, 81st Cong., 2d Sess., p. 20; Senate Report No. 2375 on H.R. 8920, 81st Cong., 2d Sess., pp. 51-2; *Philber Equipment Corporation v. Commissioner of Internal Revenue*, 237 F. 2d 129 (3rd Cir. 1956).

[12] House Report, page 24; Senate Report, pages 25-26. That respondent's chief interest in *Evans* and the instant case is the impact of Section 117(j) of the 1939 Code and Section 1231 of the 1954 Code clearly appears in footnote 7, page 11, of respondent's petition for certiorari in *Evans*.

as to useful life and the interrelated issue of salvage value. It is thus obviously desirable, and indeed, in our view, essential, for this Court also to consider and to resolve the conflict on these problems of critical importance in the interpretation and administration of the statutory depreciation allowance under the current 1954 Code. To do that, certiorari should be granted in this case.

CONCLUSION.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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August, 1959

APPENDIX A

UNITED STATES COURT OF APPEALS

For the Third Circuit

No. 12,799

THE HERTZ CORPORATION, a Corporation
(Successor by Merger to J. Frank Connor, Inc.,
a Corporation),

v.

UNITED STATES OF AMERICA,
Appellant.

On Appeal From the United States District Court
for the District of Delaware

Argued May 25, 1959

Before Kalodner, Staley, and Hastie, *Circuit Judges.*

Opinion of The Court

(Filed July 6, 1959)

By Staley, *Circuit Judge.*

Essentially this appeal presents two questions for review, namely: (1) whether "useful life" for depreciation purposes as used in Section 167(c) of the Internal Revenue Code of 1954 means the physical life of an asset for business purposes (the economic life), or the period during which

the property is useful to the taxpayer; and (2) whether in the declining balance method of depreciation,[1] authorized by Section 167(b)(2) of the 1954 Code, salvage value is inherent in the method or, rather, is a figure below which depreciation is not permitted.

This is an action for refund of income taxes paid by appellee[2] for the fiscal years ended March 31, 1954, 1955, and 1956, in the amounts of $100.15, $4,044.54, and $10,416.43, respectively. The government has appealed from an adverse judgment rendered by the District Court for the District of Delaware.[3]

Appellee's predecessor, Connor, was organized as a New Jersey corporation on April 2, 1947, and was merged with it on July 5, 1956. During the years pertinent to the inquiry, Connor was engaged in the business of renting and leasing automobiles and trucks, without drivers, in the State of New Jersey.[4]

The taxpayer had in operation during this period a preventive maintenance program which called for periodic

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[1] Under the declining balance method of depreciation, a uniform rate is applied each year to the unrecovered cost or other basis of the property; however, such rate may not exceed twice the appropriate straight line rate computed without adjustment for salvage, nor may it be applied to property with a useful life of less than three years. Under the straight line method of depreciation, the cost or other basis of the property less its estimated salvage value is deductible in equal amounts over the period of the estimated useful life of the property. Income Tax Regulations (1954 Code) § 1.167(b)-1 & 2.

[2] The Hertz Corporation is the successor by merger to J. Frank Connor, Inc., the original taxpayer herein. The claims for refund were filed by Hertz after such merger.

[3] The opinion of the district court is reported at 165 F. Supp. 261 (D.C. Del. 1958).

[4] "Renting" is the term used in the industry to describe the hiring of vehicles by salesmen, executives, engineers and tourists at stipulated rates per mile, per hour or day. "Leasing" is the term used to describe the contract hiring of vehicles for a fixed period on a relatively long-term basis (*i.e.*, by the year or for a longer period).

inspections and servicing. However, the operative condition of the vehicles was a relatively minor factor influencing replacement of the fleet. More important in this regard was the percentage of its fleet being operated regularly; the activities of its competitors; mechanical changes; climatic conditions; strikes and work stoppages; the ability to obtain new cars; whether the country was at war or peace; economic conditions in its business area; and its financial situation. None of these factors were predictable in advance.

Under the influence of these factors the holding period of appellee's cars and trucks varied considerably. The average holding period for automobiles during the 1954-1956 period was 26.17 months, and during its entire nine-year existence, 29.36 months. The corresponding average holding periods for trucks were 38.89 months and 48.26 months.

The president of the Hertz Corporation testified concerning the car rental industry, its relative youth, highly competitive nature, and the factors that influence replacement of the vehicles. Hertz owns and operates a car rental business in approximately 170 cities and licenses operations in 650 additional cities.

Appellee also presented evidence by three certified public accountants to the effect that the term "useful life" has consistently meant and still means the economic life of the asset and not the life of the asset in the hands of the taxpayer. They further indicated that their experience with representatives of the Internal Revenue Service had been that depreciation was computed on the basis of the aggregate business life of the asset regardless of changes of ownership.

Initially, in preparing its returns for the years ended March 31, 1954, March 31, 1955, and March 31, 1956, appellee

claimed depreciation on its automobiles on the basis of a four-year useful life at a 30% rate for the first two years and a 20% rate for the remaining two years. Its heavy duty trucks were depreciated on the basis of a five-year useful life, and its other trucks on the basis of a four-year useful life, both at uniform rates. The taxes so computed were paid. Subsequently, on September 14, 1956, appellee filed claims for refunds for the years 1954 and 1955, and on September 17, 1956, filed a claim for 1956. These claims for refund were based on an election in accordance with Section 1.167(c)-1(c) of the Treasury Regulations issued under the Internal Revenue Code of 1954 to utilize the declining balance method of depreciation. Inasmuch as the Commissioner failed to take any action upon the claims within a period of six months, this suit for refund was instituted.

The district court found that by 1954 the term "useful life" had come to mean the entire physical life (economic life) of the asset in question; that in enacting the Internal Revenue Code of 1954 Congress intended to change its meaning to useful life of the asset to the taxpayer; that Section 1.167(a)-1(b) of the Treasury Regulations so defining useful life was valid; that inasmuch as the Commissioner had acquiesced in the economic life construction of the term useful life, the appellee was entitled to rely thereon and the regulations could not be applied retroactively; and finally that salvage value is inherent in the declining balance method of depreciation and therefore there is no authority for application of a limit (representing reasonable salvage value) below which assets may not be depreciated. Accordingly, the district court entered judgment for Hertz for the total sum of $14,367.32.

The initial question posed for our consideration relates to the meaning to be ascribed to the term useful life which first appeared in the tax statutes in Section 167(c) of the 1954 Code, limiting the use of the declining balance method

of depreciation to property with a useful life in excess of three years. The term was not defined therein. At a much earlier date, however, the term became embedded in the tax regulations relative to depreciation. Accordingly, it is essential for us to consider the history of the various depreciation provisions and the regulations implementing them.

The basic depreciation provision contained in the Revenue Act of 1913, 38 Stat. 114,[5] has remained substantially unchanged throughout all later enactments. Later enactments added provisions regarding obsolescence and incorporated "property held for the production of income" within the purview of depreciable property. However, the theory of depreciation is the same today as it was in 1927 when the Supreme Court considered the problem in *United States* v. *Ludey*, 274 U.S. 295, 300-301:

> "* * * The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost."

The regulations issued by the Commissioner throughout the history of the income tax have implemented this broad statutory scheme and therein first appeared the term useful life. Prior to issuance of the 1956 regulations, however, no definition of this term was incorporated therein.

Since it is hornbook law that in interpreting undefined statutory language the courts look to common usage and general acceptance, both parties to this action have diligently searched the history of the term. However, as is not uncommon, they came to different conclusions. The gov-

[5] "* * * a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in business * * *."

ernment contends that the term useful life means and has always meant the period during which the asset is of use to the taxpayer, while Hertz asserts that it has always meant the economic life of the asset. Thus, neither party supports the opinion of the district court that until 1954 and the enactment of the new Internal Revenue Code the term meant economic life of the asset but Congress changed its meaning in enacting the new code. On the contrary, the parties agree that the meaning of the term, whatever it may be, has remained unchanged throughout the period of its use; i.e., that the 1954 Code was not intended to nor did it change the meaning. Our consideration of the 1954 enactment convinces us that the parties are correct and that Congress in 1954 intended no change in the meaning of the term. The view we take of the case thus requires us to consider the contentions of the parties regarding the accepted meaning of useful life.

Thorough study of the references points up one undisputed fact; that is, few of the cases, treatises, or regulations have addressed themselves to this very problem. The language found therein is imprecise, unclear, and ambiguous as regards the term useful life. Until the enactment of the 1954 Code and the authorization of the declining balance method of depreciation for assets with a three-year useful life, the problems regarding depreciation involved the reasonableness of the period of useful life. Few, if any, gave a thorough consideration to whether useful life meant economic life or not; rather, most taxpayers were interested in short depreciation periods. Further, most depreciable assets were such as were held by the taxpayer until they were ready to be scrapped and disposed of as no longer useful for their intended purpose.

Hertz's argument in support of the proposition that useful life has always meant the economic life of an asset is basically three-pronged; judicial interpretation, adminis-

trative practice, and expert opinion. As regards judicial interpretation—we have been cited to a number of Board of Tax Appeals and Tax Court decisions.[6] However, the issue was not squarely presented nor was any theory of useful life formulated therein; rather, the questions posed in the cases were treated as factual in nature. Thus they are of little, if any, use to us as precedents. It was also noted that *Philber Equipment Corp.* v. *Commissioner of Internal Revenue*, 237 F. 2d 129 (C.A. 3, 1956), utilized the term useful life in the sense contended for by Hertz. However, a close reading of that opinion indicates that its use of the term may well support either contention. Moreover, the use of the term was not essential to the holding nor was that issue litigated on appeal. Finally, we note two recent appellate opinions in which this very question was presented. In *Evans* v. *Commissioner of Internal Revenue*, 264 F. 2d 502 (C.A. 9, 1959), the Ninth Circuit found in favor of the contention that useful life has always meant economic life, while in *United States* v. *Massey Motors, Inc.*, 264 F. 2d 552 (C.A. 5, 1959), the Fifth Circuit came to the conclusion that it has consistently meant the length of time the assets are expected to be usable to the taxpayer. See also *Cohn* v. *United States*, 259 F. 2d 371 (C.A. 6, 1958).

In regard to the administrative practice, it is only fair to note that some of the pronouncements are ambiguous. However, Hertz itself refers us to what we are convinced is a highly significant statement of Bureau position; i.e., Treasury Department Bulletin F. The following statement

[6] *West Virginia and Pennsylvania Coal & Coke Co.*, 1 B.T.A. 790 (1925); *J. R. James*, 2 B.T.A. 1071 (1925); *Merkle Broom Co.*, 3 B.T.A. 1084 (1926); *Max Kurtz*, 8 B.T.A. 679 (1927); *Whitman-Douglas Co.*, 8 B.T.A. 694 (1927); *Wallace G. Kay*, 10 B.T.A. 534 (1928); *Sanford Cotton Mills*, 14 B.T.A. 1210 (1929); *John A. Magnin Estate, Ltd.*, 17 B.T.A. 394 (1929); *W. N. Foster*, 2 T.C.M. 595 (1943); *Nat Lewis*, 13 T.C.M. 1167 (1954); and *Pilot Freight Carriers, Inc.*, 15 T.C.M. 1027 (1956).

appears under the heading "Allowance for Depreciation and Obsolescence."

> " * * * The proper allowance for exhaustion, wear and tear, including obsolescence, of property used in trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property *in the business*, equal the cost or other basis of the property." (Emphasis added.)

Although the Internal Revenue Service originally disclaimed any authoritative standing for the specific items treated in Bulletin F, when it was republished in January, 1942, the following was added:

> " * * * It contains information and statistical data relating to the determination of deductions for depreciation and obsolescence, from which taxpayers and their counsel may obtain the *best available indication of Bureau practice* and the trend and tendency of official opinion in the administration of pertinent provisions of the Internal Revenue Code and corresponding or similar provisions of prior Revenue Acts." (Emphasis added.)

Finally, Hertz relies upon the expert opinion of three witnesses, partners in the accounting firms of Ernst & Ernst, Price Waterhouse & Co., and Arthur Andersen & Co., respectively. They were called "to give testimony with respect to their experience in the application of the depreciation provisions of prior revenue acts, and specifically, to give their opinion as to the meaning of the term 'useful life' as it is consistently used and understood for the purposes of depreciation." Whatever persuasiveness this testimony might have is lessened when it is noted that Montgomery's Federal Taxes, 37th ed., 1958, ch. 6, p. 4 et seq., edited by four partners in the accounting firm of Lybrand, Ross Bros. & Montgomery, is directly to the contrary.

Among the other evidence relied upon by Hertz is the fact that in 1942 the depreciation regulations were significantly changed. Prior to December 8, 1942, Section 19.23 (*l*)-1 provided an allowance for depreciation which "plus the salvage value, will, at the end of the *useful life of the property in the business*, equal the cost or other basis of the property * * *." (Emphasis added.) The 1942 regulation eliminated the words "property in the business" and substituted the words "depreciable property." Although this change might appear to support Hertz's position on a cursory glance, a study of the legislative history of the amendment indicates that the change was effected as a result of the amendment of the act so as to include property held for the production of income within the class of depreciable property. No other significance for the change is warranted. See *United States* v. *Massey Motors, Inc.*, 264 F. 2d 552 (C.A. 5, 1959).

We are of the opinion that the accepted meaning of the term useful life has always been the period of usefulness of the asset to the taxpayer in his business. Such a conclusion is in accord with the fundamental concept of depreciation as set forth in *United States* v. *Ludey*, 274 U.S. 295 (1927), as further enunciated in Bulletin F, and as adhered to by the appellate courts. *United States* v. *Massey Motors, Inc., supra; Cohn* v. *United States*, 259 F. 2d 371 (C.A. 6, 1958). Nothing in the legislative history of the 1954 Code leads us to a contrary conclusion; rather, if anything, it supports the view here expressed and indicates, as the district court noted, that Congress was using the term useful life to mean the period during which an asset is useful to a taxpayer. Therefore, since the automobiles in question had a useful life of less than three years, Hertz is not entitled to depreciate them under the declining balance method of depreciation.

The question concerning the proper application of salvage value to the declining balance method of depreciation need not detain us for long. Congress unmistakably in-

dicated in 1954 when it first authorized the new method of depreciation that "The changes made by your committee's bill merely affect the timing and not the ultimate amount of depreciation deductions with respect to a property." H. Com. Report on H.R. 8300, 83d Cong., 2d Sess., 3 U.S. Code Cong. & Adm. News 4017, 4049 (1954). Thus, what is changed is the acceleration of depreciation deductions in earlier years but not the total amount of such deductions. We can find no support for Hertz's contention that, since it is theoretically impossible to ever depreciate the entire value of the asset under this system, Congress intended that a taxpayer should be allowed to use the declining balance method to depreciate the asset below a reasonable salvage value. On the contrary, the statement quoted above appears to directly contradict such an assertion. The gist of Hertz's oral argument on this issue is that Congress intended to encourage replacement of equipment through a liberalized depreciation method more in accord with economic realities; that the treatment or lack of treatment of salvage value would also encourage that end by giving a tax benefit to the taxpayer; therefore, Congress must have intended that salvage value not be a limit upon depreciation under the declining balance method. The argument, if it has any validity, should be addressed to the Congress and not to the courts, especially in view of the clear and precise intention of Congress manifested in its committee reports.

The judgment will be reversed.

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the District of Delaware and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this case be, and the same is hereby reversed.

July 6, 1959

APPENDIX B

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION

(a) *General rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of certain methods and rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) *Limitations on use of certain methods and rates.*—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

* * * * *

(f) *Basis for depreciation.*—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

* * * * *

(Int. Rev. Code § 167, 26 U.S.C.A. 1955 ed., § 167 [Supp., 1958].)

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gain and losses)), adjusted as provided in section 1016.
(Int. Rev. Code § 1011, 26 U.S.C.A. § 1011 [1955].)

SEC. 1012. BASIS OF PROPERTY—COST

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.
(Int. Rev. Code § 1012, 26 U.S.C.A. § 1012 [1955].)

SEC. 1016. ADJUSTMENTS TO BASIS

(a) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * * * *

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws.

* * * * *

(Int. Rev. Code § 1016, 26 U.S.C.A. 1955 ed., § 1016 [Supp., 1958].)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS

(a) *General rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business . . . exceed the recognized losses from such sales [and] exchanges . . . such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months.

* * * * *

(b) *Definition of property used in the trade or business.*—For purposes of this section—

(1) *General rule.*—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months . . . which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year [or]

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . .

*   *   *   *   *   *

(Int. Rev. Code § 1231, 26 U.S.C.A. 1955 ed., § 1231 [Supp., 1958].)

Internal Revenue Code of 1939:

Sec. 117(j). *Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business.*

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(*l*) held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . .

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business . . . exceed the recognized losses from such sales [and] exchanges . . . such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. . . .

*   *   *   *   *   *

(Int. Rev. Code § 117(j), 26 U.S.C.A. 1945 ed., § 117(j) [Supp., 1945].)

Treasury Regulations on Income Taxes (1954 Code):

§ 1.167(a)-1. *Depreciation in general.*—

(a) *Reasonable allowance.*—Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer

for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only

when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167 (d)-1.

(c) *Salvage.*—Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made

in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

* * * * *

§ 1.167(b)-0. *Methods of computing depreciation.*—

(a) *In general.*—Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property.

* * * * *

§ 1.167(b)-1. *Straight line method.*—

(a) *Application of method.*—Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

* * * * *

§ 1.167(b)-2. *Declining balance method.*—

(a) *Application of method.*—Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(f), adjusted for depreciation

previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(b)(2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See Section 167(c) and § 1.167(c)-1 for restrictions on the use of the declining balance method.

* * * * *

§ 1.167(c)-1. *Limitations on methods of computing depreciation under Section* 167(b) (2), (3), *and* (4).—

* * * * *

(c) *Election to use methods.*—Subject to the limitations set forth in paragraph (a) of this section, the methods of computing the allowance for depreciation specified in section 167 (b) (2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) above, he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any property shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167(b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ROBLEY H. EVANS and JULIA M. EVANS, *Petitioners,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

No. 15,985
Jan. 26, 1959

Upon Petition to Review Decision of the Tax Court of the United States

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Before: POPE, HAMLEY and JERTBERG, Circuit Judges.

JERTBERG, Circuit Judge:

The main issue presented to this Court on the petition for review of the decision of the Tax Court of the United States centers on the rate of depreciation to which the taxpayers are entitled on automobiles used by them in their business of leasing automobiles to a corporation which was engaged in the business of leasing and renting automobiles to the public.

The Tax Court entered its decision finding deficiencies in income tax due from taxpayers for the years 1950 and 1951 in the respective amounts of $13,191.52 and $13,048.12.

There appears to be no dispute between the parties as to the character of the taxpayers' business or the manner in which it was conducted during the years in question.

During the years 1950 and 1951 Robley H. Evans and Julia M. Evans[1] were husband and wife. During these

[1] Julia M. Evans is a party solely because of the filing of joint returns for the taxable years involved.

years Robley H. Evans (hereinafter designated as petitioner) was engaged in the business of leasing automobiles to Evans U-Drive, Inc. (hereinafter called U-Drive) at a monthly rental of $45.00 per month per automobile. U-Drive was engaged in the business of leasing and renting automobiles to the public, which business was managed by the petitioner.

The lease agreement between petitioner and U-Drive provided that petitioner was obligated to furnish U-Drive with a sufficient number of automobiles to enable it to conduct and operate an automobile leasing and renting business in an efficient manner.

During the taxable years under review U-Drive engaged in two types of rental activities, which for convenience might be termed short term rentals and extended rentals. Short term rentals varied from a few hours to several weeks. Extended rentals varied from eighteen months to thirty-six months, and accounted for thirty to forty per cent of automobile rentals.

Under the lease agreement with U-Drive, petitioner retained title to the automobiles, and had the right to sell and dispose of any of them at any time.

Petitioner periodically owned more automobiles than were necessary for the efficient operation of short term rentals. When this situation arose he would examine the cars in use and sell the number which were not needed. The oldest and least desirable cars were sold first. When sold, such cars had been driven on average of 15,000 to 20,000 miles, and were generally in good mechanical condition. Many automobiles were sold at the end of the tourist season. When sold, each car had been in use about fifteen months. These cars could have been used longer than they were, but customers of U-Drive demanded late model cars that were currently in style.

Automobiles to be used for extended rentals were purchased by petitioner when needed and leased to others by U-Drive. At the termination or cancellation of such leases, the automobiles were returned to petitioner, who sold them. When sold, such cars had been driven an average of 50,000 miles. They were generally in good physical condition and state of repair at the time of disposition, and petitioner could have continued to use them longer than he did.

Petitioner sold most of his surplus automobiles to used car dealers, jobbers, or brokers, and as a general rule the automobiles when sold brought current wholesale prices. Petitioner purchased new cars from local dealers, usually at factory prices.

Petitioners' tax returns for 1950 and 1951 revealed that he sold 140 and 147 automobiles respectively during those years. The average cost, sales price, depreciation claimed, and gain per car were approximately as follows:

Year	Cost	Sales Price	Depreciation Claimed	Gain
1950	1650	1380	515	245
1951	1495	1395	450	350

In such tax returns the amounts of depreciation taken were computed and deductions claimed on the basis that the automobiles had an estimated useful life of four years, with no salvage at the end of the four-year period.

The Tax Court determined:

1. That the automobiles which petitioner leased to U-Drive during the taxable years for use under extended rentals had a useful life of three years and a salvage value of $600.00;

2. That the automobiles which he leased to U-Drive for use under short term rentals had a useful life of fifteen months and a salvage value of $1,375.00;

3. If the undepreciated [adjusted] cost of the automobiles in service at January 1, 1950 is less than $600.00 and $1,375.00 for the respective classes of automobiles, then that amount will be the salvage value of those automobiles.

Computations based upon such decision resulted in the amounts of deficiency above mentioned for the years under review.

In the notice of deficiency directed to petitioner, the Commissioner stated that "It has been determined that *the average useful life of the automobiles used in your business* based on your actual experience was not in excess of seventeen months and the average *salvage value* of said automobiles at the *end of their useful life in your business* was not less than $1,325.00 or the adjusted basis of said automobiles as of January 1, 1950, whichever amount was the lesser." (Emphasis added)

The Tax Court found that "The surplus automobiles sold by Robley (Evans) could have been used longer than they were; however, customers demanded late model automobiles that were currently in style. Older automobiles did not have much value as rental vehicles. During the taxable years, Robley (Evans) sold the automobiles used by U-Drive in the short-term rental phase of its business after they had been used about 15 months. And he usually sold the automobiles which had been leased for extended terms as soon as the lease was terminated." The Tax Court further found that 30 to 40 per cent of the automobiles leased by petitioner to U-Drive were on the extended rental basis, which period was from 18 months to 36 months, and that as a general rule the automobiles were sold at current wholesale prices. In its opinion the Tax Court stated that petitioner had consistently claimed deductions for depreciation (apparently since 1936) on the basis that his automobiles had a useful life of four years, with no salvage value at the end of the four-year period.

It is the petitioner's position on this review that until the opinion of the Tax Court herein, judicial interpretation, administrative practice under the 1939 Code, and practice in the accounting profession generally, had long agreed that, for the purpose of the depreciation deduction, the term "useful life" means the physical, economic or functional life of the property subject to the depreciation allowance, and the term "salvage value"—the value remaining in depreciable property at the end of its physical, economic or functional life—means its residual or scrap value.

Analysis of the findings of fact, conclusions of law, and decision of the Tax Court unmistakably reflect that the Tax Court measured "useful life" by the holding period of the automobiles leased by petitioner to U-Drive, and measured "salvage value" by the estimated proceeds which might be realized upon the disposition of such automobiles.

The Tax Court's opinion contains no discussion as to the legal signification of the terms "useful life" and "salvage value". The concepts of such terms and the contentions in relation thereto as advanced by the petitioner were not mentioned. The question presented by this review is a narrow one, although not without its difficulties. In most instances, an asset used in the trade or business remains in the service of the taxpayer until its economic usefulness has been exhausted. Under such circumstances, no problem arises as to the useful life of the asset, and the value remaining in the asset at the end of such useful life—its salvage value—is generally its scrap or junk value. The problem is acute with respect to taxpayers, the nature of whose business requires, for various reasons, a policy of disposing of depreciable assets while such assets still possess substantial value, and which property brings on disposal prices considerably in excess of the scrap or junk value. Such a business is the type in which petitioner engages.

It is our view that the issue presented by the conflicting concepts of "useful life" and "salvage value" involve principally taxpayers engaged in such type of business whose tax years under the Internal Revenue Code of 1939 are open for review and assessment by the Commissioner. This issue may also involve taxpayers engaged in such type of business whose tax years prior to the enactment of Section 167 of the Internal Revenue Code of 1954 and the issuance of Treasury Regulations T.D. 6182 are likewise open for review and assessment. See *The Hertz Corporation, etc.* v. *United States*, U.S. District Court, District of Delaware, (1958), 58-2 U.S.T.C., Paragraph 9720.

In enacting section 167 of the Internal Revenue Code of 1954 (Title 26 U.S.C.A., section 167), Congress authorized several new methods for computing depreciation for taxable years ending after December 31, 1953. Section 167(b) states that a "reasonable allowance" as used in section 167(a) shall include an allowance computed in accordance with regulations prescribed by the Secretary, under any of the prescribed methods and rates. Sections 167(b) and 167(c) prescribe allowable methods and rates for computing depreciation, as well as certain limitations on the use of such methods. The allowable methods are the straight line method, the declining balance method, the sum of the years-digits method, and any other method productive of an annual allowance which does not exceed the allowance computed under the declining bal[illegible] method. If an allowance is reasonable under se[illegible] 167(a), it shall not be limited or reduced by any provision contained in section 167(b). Section 167(c) restricts the accelerated method contained in section 167(b) to new construction and to new tangible property with a useful life of three years or more.

Regulations under the Internal Revenue Code of 1954 were issued June 7, 1956, T.D. 6182, 1956—1 Cum. Bul. The depreciation provisions of these regulations relevant to this discussion are set forth in section 1.167(a)-1. Sec-

tion 1.167(a)-1-(a) states that the allowance [reasonable allowance under section 167(a) of the Code] is "that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan [not necessarily at a uniform rate], so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property * * * An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. * * * The allowance shall not reflect amounts representing a mere reduction in market value."

Section 1.167(a)-1-(b) states "For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. * * *"

Section 1.167(a)-1-(c) states, "Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. * * * If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. * * *"

Finally, for the guidance of taxpayers, there are now official definitions of the terms "useful life" and "salvage value", and definite rules for their application.

There can be no dispute over the fact that the Tax Court applied to the facts of this case definitions of "useful life" and "salvage value" which appeared for the first time in Regulations T.D. 6182, promulgated under the 1954 Code.

The Commissioner does not seriously argue otherwise. His position appears to be that the concepts of "useful life" and "salvage value" embodied in the new regulations have been applied under all Revenue Acts and regulations since 1918, including the Internal Revenue Code of 1939, and regulations issued thereunder. The petitioner vigorously disputes such position.

We will now proceed to explore the validity of the petitioner's contention that until the opinion of the Tax Court herein, judicial interpretation, administrative practice under the 1939 Code, and practice in the accounting profession, had long agreed that, for the purpose of the depreciation deduction, the term "useful life" means the physical or economic life of the property subject to the depreciation allowance, and that the term "salvage value"—the value remaining in depreciable property at the end of its physical or economic life—means its residual or scrap value.

The basic statute on depreciation in the Internal Revenue Code of 1939 is section 23. This section in its relevant part provides: "Sec. 23. Deductions from gross income—In computing net income there shall be allowed as deductions * * * 1. Depreciation—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) * * *"

This basic provision relating to depreciation of property used in a trade or business has been a part of every Internal Revenue Act since 1918.[2] This same basic provision appears in the Internal Revenue Code of 1954.[3]

In none of the depreciation provisions contained in revenue acts from the Revenue Act of 1918 has Congress seen fit to define the term "reasonable" in providing for a

[2] Sec. 234(a)-1 and Sec. 241(a)-8 of the Revenue Act of 1918, c. 18, 14 Stat. 1057.

[3] Sec. 167, Title 26 U.S.C.A.

"reasonable allowance" for exhaustion, wear and tear. This basic provision is so general as to render an interpretative regulation appropriate. *Morrissey, et al., Trustee v. Commissioner of Internal Revenue*, 296 U.S. 344; *Helvering, Commissioner of Internal Revenue v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110.

Treasury Regulations 111 (1942) were promulgated under the Internal Revenue Code of 1939, and are applicable to the years 1950 and 1951, which are the taxable years under review. The relevant portions of Regulations 111 are contained in section 29.23(l). Pertinent extracts from such section are: "* * * The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis * * *" Section 29.23(l)-1.

"The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. * * *" Section 29.23(l)-4.

"The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, * * * The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. * * *" Section 29.23(l)-5.

The first appearance of the terms "useful life" and "salvage value" in Treasury Regulations was in Treasury Regulations 45, Article 161 (1919), effective for the calendar years 1918-19 and 1920. Article 161 provided in part, as

follows: "The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the *useful life of the property in the business* will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost * * *" (Emphasis added)

Article 165 of the same Regulations provided in part as follows: "The capital sum to be replaced *should be charged off over the useful life of the property* * * *" (Emphasis added)

Similar wording with changes not material to the problem before us appeared in subsequent Treasury Regulations through Regulations 103, Section 12.23(l)-1-5, effective for the tax years 1939-40 and 1941. The words "in the business" which appeared in Article 161 of Regulations 45 continued to appear in successive regulations until the issuance of Regulations 111 in 1942. No definition or further explanation of the terms "useful life" or "salvage value" appeared in any of the regulations to which reference has been made until the issuance of Treasury Regulations T.D. 6182, promulgated under the 1954 Revenue Code. The terms "useful life" and "salvage value" are not defined or explained in Regulations 111. The language of the Regulations does not limit "useful life" to the useful life of the depreciable assets in the business of the taxpayer or to the period during which such assets are held by the taxpayer.

The significance, if any, to be attached to the omission of the words "in the business" from Regulations 111 is obscure. We attach no significance thereto because in our view the practice and position of the Commissioner has been the same under Regulations 45 and succeeding regulations up to T.D. 6182, except for a few recent cases un-

der Regulations 111 of the Internal Revenue Code of 1939,[1] in which the Commissioner asserted the concepts of "useful life" and "salvage value" embodied in T.D. 6182.

From the practice of the Commissioner over the years, it appears to us that the phrase "in the business" included in earlier regulations simply defined the type of assets which were subject to the depreciation allowance. The omission of such phrase from Treasury Regulations 111 would not furnish the basis for an interpretation of the term "useful life" which it did not have when the phrase appeared in the regulations.

As stated above, the basic statutory provision relating to depreciation of property used in a trade or business was so general as to render an interpretative regulation appropriate. Section 3791 of the Internal Revenue Code of 1939 states that the Commissioner, with the approval of the Secretary, "shall prescribe and publish all needful rules and regulations for the enforcement of this title." Pursuant to such Congressional direction, the Commissioner issued Regulations 111, of which section 29.23(1) is a part. This section was prepared by the department charged with the enforcement of the Act. In carrying out the Congressional directive, it was necessary for the Commissioner to select some base on which the annual allowance for depreciation might be measured. The language in section 29.23(1) indicates that the Commissioner selected as the base the estimated physical or economic life of the depreciable asset, and not the estimated holding period of such asset in the hands of the taxpayer. The section represents a fairly contemporaneous construction by the Commissioner of the statute. The section is not in conflict

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[1] *Koelling vs. United States*, U.S. District Court for the District of Nebraska (1957), 57-1 U.S.T.C., Paragraph 9453; *Pilot Freight Carriers, Inc. vs. Commissioner* (1956), 15 Tax Court Memo 1027; the instant case (1957), 16 CCH, Tax Court Memo 156.

with the express provisions of the statute. It is reasonably adapted to the enforcement of the Act. If there exists any doubt as to the construction to be placed on the language of section 29.23(4), such doubt disappears in the light of the consistent practice and position of the Commissioner from 1939 to 1956. No decision of the United States courts or the Tax Court has been called to our attention, except the very recent decisions heretofore mentioned, in which the Commissioner asserted that the term "useful life" should be limited to the period during which the depreciable asset was held by the taxpayer. On the contrary, the consistent, long-continued practice and position of the Commissioner were that "useful life" of the depreciable asset was its estimated physical or economic life.

Our attention has been directed to certain pronouncements of the Commissioner dealing with the general subject under review.[5] In each of such pronouncements, it is evident that the Commissioner's concept of the term "useful life" was not measured by the period in which the depreciable asset was useful in the taxpayer's business, but was measured rather by the economic or physical life of the depreciable asset.

Further evidence of the position of the Commissioner is drawn from his acquiescence in decisions of the Board of Tax Appeals[6] which measured "useful life" of the depreciable asset not by the holding period of such asset by the particular taxpayer, but by the economic or physical life of such asset.

In the case of *General Securities Co.*, BTA Memo. CCH

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[5] O.D. 845, Cumulative Bulletin—January-June 1921, page 178. I.R. Bulletin 108, 1953—1 CB 185; and Rev. Rul. 54-229, 1954—1 CB 124.

[6] *Sanford Cotton Mills*, 14 BTA 1210 (1929), Acq. X-2 CB 63; *Merkle Broom Co.*, 3 BTA 1084 (1926), Acq. V-2 CB 2; *Max Kurtz, et al.* 8 BTA 679 (1927), Acq. VII-1 CB 18.

Dec. 12,500-D (1942), affirmed per curiam 137 F. 2d 201, the taxpayer claimed a useful life of three years for automobiles used in its business. The taxpayer kept its cars one or two years, and when traded in after one year the cars retained a value of from one-third to one-half of their original value. The Commissioner attempted to compel the taxpayer to depreciate such automobiles over a useful life of more than three years. The Tax Court found that the normal useful life of such automobiles was three years.

In the recent case of *Philber Equipment Corp.* vs. *Commissioner of Internal Revenue,* 237 F. 2d 129 (C.A. 3d 1956), taxable years 1951-52 were involved. The taxpayer was engaged in the business of furnishing trucks, trailers and tractors to the public on a lease basis. The single issue in that case was whether the motor vehicles owned by taxpayer were "held primarily for sale to customers in ordinary course of petitioner's trade or business" within the meaning of Sections 117(a) and (j) of the Internal Revenue Code of 1939, 26 U.S.C.A. section 117(a) and (j). The court stated at page 130: "During the taxable years, existing conditions made it difficult or impossible to release most of the equipment. Taxpayer knew that when equipment was purchased, it would probably be able to rent the equipment for a period substantially less than its useful life, and sale of the equipment would follow expiration of a lease." The Commissioner stated in his brief[7] filed in that case, "Because of existing conditions taxpayer knew when it purchased equipment that it would likely be able to rent such equipment only for a period that was substantially less than its useful life." (Page 5 of brief). At page 11 of the brief, the Commissioner stated, "* * * all of the leases involved were only for a one-year term, a period substantially less than the useful life of this type

[7] Brief of respondent, *Philber Equipment Corp.* vs. *Commissioner of Internal Revenue*, C.A. 3rd, Docket No. 11,860.

of equipment as its resale in the tax years and re-lease in later years demonstrated." The statements of the Commissioner in the above case are simply confirmatory of the position taken by the Commissioner over a period of many years.

Petitioner calls attention to Internal Revenue Bulletin "F", which was issued in 1920 and revised in 1942. It was republished as Internal Revenue Bulletin 173 in 1955. This bulletin sets forth general depreciation policy and tables of estimated lives of particular kinds of assets. This bulletin is titled "Income Tax Depreciation and Obsolescence, Estimated Useful Lives and Depreciation Rates." The title pages states, "This bulletin supersedes Bulletin 'F' (revised January 1931) and 'Depreciation Studies' (published January 1931). It contains information and statistical data relating to the determination of deductions for depreciation and obsolescence, from which taxpayers and their counsel may obtain the best available indication of Bureau practice and the trend and tendency of official opinion in the administration of pertinent provisions of the Internal Revenue Code and corresponding or similar provisions of prior Revenue Acts. It does not have the force and effect of a Treasury Decision and does not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury."

In the first paragraph of the Introduction (Part I, page 1 of the Bulletin) it is stated: "The Federal income tax in general is based upon net income of a specified period designated as the taxable year. The production of net income usually involves the use of capital assets which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption usually is gradual, extending over a period of years. It is ordinarily called depreciation, and the period over which it extends is the normal useful life of the asset."

The first paragraph on page 3, under the heading "Probable Useful Life—Rates of Depreciation and Obsolescence" is as follows: "In general. The amount of the annual deduction allowable for depreciation is ordinarily dependent upon the expected useful life of the asset. The factors which determine the useful life of property in a trade or business have already been discussed briefly in the Introduction. These factors are wear and tear and decay or decline from natural causes; and also various forms of obsolescence attributable to the normal progress of the art, economic changes, inventions, and inadequacy to the growing needs of the trade or business. Two principal forms or types of obsolescence are generally recognized, that is, normal obsolescence and extraordinary special obsolescence."

At page 7, under the heading of "Salvage" it is stated: "Salvage value is the amount realizable from the sale or other disposition of items recovered when property has become no longer useful in the taxpayer's business and is demolished, dismantled, or retired from service. * * *"

Under the heading "Lives of Depreciable Property" is the following: "In this compilation are listed for each industry the useful lives of various assets, including wherever practicable lives for composite accounts and group accounts. * * * All lives are given without fractional years. In practice, however, fractions may be used."

The recommended useful life on motors and other vehicles appears on page 52. Therein it is stated, "Motor vehicles included in this classification are those used by commercial enterprises other than public utility and construction. Lives considered reasonable are indicated below:

Automobiles:	Years
Passenger	5
Salesman	3 * * *

In the instant case, as noted above, the petitioner used a useful life of four years in his depreciation schedules.

While we recognize that Bulletin "F" does not have the force of law, we do believe that a fair construction of the pertinent provisions of such Bulletin, aided by the practice of the Commissioner, reasonably indicates that the Commissioner did not consider as a factor in determining depreciation the expected or intended disposal plans of the taxpayer with respect to property used in his trade or business, nor did the Commissioner consider that the useful life of an asset was to be measured by the estimated holding period of such asset by the taxpayer.

Decisions of the Board of Tax Appeals and the Tax Court[8] extending over many years have, but with little discussion, measured the useful life of a depreciable asset used in the trade or business of the taxpayer not by the holding period of such asset by a particular taxpayer but by the economic or physical life of such asset.

In a recent decision of the United States District Court[9] involving the same tax years as in the instant case, the same type of business, and the same disposal practice as to automobiles, the court upheld the taxpayer's depreciation practice based on a useful life of three years. Similar holdings were made in district court cases.[10]

[8] *West Virginia & Pennsylvania Coal & Coke Co.*, 1 BTA 790 (1925); *J. R. James*, 2 BTA 1071 (1925), Acq. V-1 CB 3; *Wallace G. Kay*, 10 BTA 534 (1928), Acq. VII-1 CB 17; *W. N. Foster, et al.*, 2 TCM 595 (1943); *John A. Maguire Estate, Ltd.*, 17 BTA 394 (1929), Acq. IX-1 CB 34; *Nat Lewis*, 13 TCM 1167 (1954); and *Whitman-Douglas Co.*, 8 BTA 694 (1927).

[9] *Massey Motors, Inc. vs. United States of America* (U.S. District Court, S.D. Florida (1957), 156 F. Supp. 516.

[10] *Davidson vs. Tomlinson* (U.S. District Court, S.D. Florida, 1958), reported in 58-2 U.S.T.C., Paragraph 9739; *Lynch Davidson Motors, Inc. vs. Tomlinson* (S.D. Florida, 1958), reported at 58-2 U.S.T.C., Paragraph 9738.

In *The Hertz Corporation, etc. v. United States, supra*, the litigation arose under the Internal Revenue Code of 1954, the tax years involved being the years ending March 31, 1954, 1955 and 1956. The district court refused to apply the concept of "useful life" set forth in T.D. 6182 to taxable years prior to the promulgation of such regulations. The court stated: "The final question is whether or not, under the circumstances, the Commissioner may apply these regulations retroactively to include years prior to their promulgation. Retroactive laws are not favored. Long prior to the issuance of the new regulations in 1956, the Commissioner by his pronouncements and conduct had apparently acquiesced in the construction of 'useful life' given to the phrase by business and accounting circles and had been permitting taxpayers to make use of the declining-balance method of depreciation in situations similar to this. Nor did the language of the regulations (prior to that now under consideration) give any indication that the hitherto long-settled interpretation of the term would be changed. Furthermore, when the words 'useful life of the depreciable property' were inserted in the Regulations in 1942, they were capable of the construction that 'useful life' meant the whole physical life of the property.

"Taxpayers had a right to file their returns in reliance upon the Commissioner's long-continued interpretation of his own Regulations. Here a new regulation has been promulgated defining the term 'useful life' pursuant to a statute which for the first time has employed the term and where the intention of Congress with respect to its definition is clearly contrary to the interpretation, as evidenced by conduct and frequent pronouncements, which the Commissioner has given it in the past. Common justice requires that it be given a prospective construction only. * * * "

The long-continued and consistent practice and position of the Commissioner in measuring useful life by the physi-

cal or economic life of the depreciable asset were reflected in testimony before the Tax Court. At the trial in the Tax Court, two witnesses testified on behalf of petitioner. Both were certified public accountants licensed to practice their profession in several states, and both were admitted to practice before the Treasury Department. Each was a member of a separate accounting firm which practiced accounting nationwide. Each witness stated that he had had experience representing taxpayers before the Internal Revenue Service on depreciation matters. One witness had practiced his profession since 1930, and the other since 1934. Both testified that in the accounting profession the term "useful life" for depreciation purposes denoted the physical life or economic life of a particular asset, and that the term "salvage value" denoted the junk or scrap value of an asset at the expiration of its useful life. Both testified that in their experience in dealing with the Internal Revenue Service prior to 1954, on the subject of depreciation, the practice of the Internal Revenue Service was to apply the same concepts of such terms as such concepts were generally understood in the accounting profession. The respondent offered no testimony on the subject. The Tax Court stated, in admitting such evidence, that such testimony was not controlling.

In light of the language of Section 29.23(1), the consistent practice and position of the Commissioner over many years, the interpretation placed on the term "useful life" by decisions of the Tax Court extending over a long period, we hold that under the Internal Revenue Code of 1939 the Tax Court erred when it measured useful life of the depreciable assets involved here by the period during which such assets were held in the business of petitioner instead of the physical or economic life of such assets. The application by the Tax Court of an erroneous concept of "useful life" necessarily requires a re-determination by the Tax Court of "salvage value". The Tax Court determined

salvage value to be the estimated proceeds which would be realized from such assets when they were no longer useful in the business of petitioner and were to be disposed of by him, instead of the estimated proceeds which would be realized upon the sale or other disposition of such assets at the end of their physical or economic life. We do not agree with the petitioner's contention that the value remaining in such assets at the end of their physical or economic life necessarily means scrap or junk value. Initially, petitioner should have estimated salvage value upon acquisition of such assets and such value should have been adjusted at the end of each taxable year if conditions then existing reasonably indicated that a different value would probably be realized at the end of the physical or economic life from the sale or other disposition of such assets.

The period over which useful life—meaning the physical or economic life—extends and the salvage value at the end of such period are questions of fact to be determined by the Tax Court on the remand of this cause.

In support of the decision of the Tax Court, the Commissioner argues, *inter alia,* that obsolescence was the principal factor in the depreciation of petitioner's automobiles, and that the depreciation deduction must be based upon and take into consideration obsolescence as well as exhaustion caused by physical wear and tear. The cogency of such observation is not clear to us unless the Commissioner intends to suggest that petitioner should have but failed to claim depreciation based on obsolescence in addition to claiming depreciation caused by exhaustion through wear and tear. No meaningful mention of the word "obsolescence" appears in the in the findings, conclusions, decision of the Tax Court, or elsewhere in the record.

Regulations 111 covering the taxable years here in issue provide in section 23.23(1)-6, in part: "With respect to

physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions *that will result in its being abandoned at a future date prior to the end of its normal useful life,* so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made. (Emphasis added) There is no evidence in the record which suggests that obsolescence is a factor which should be considered in this case. The foundation for obsolescence is, according to the Regulations, the expected early abandonment of the property. The term "abandon" has been held not to include property which was to be sold at a time when it had substantial value and was to be used for other purposes instead of being scrapped. *The Olean Times-Herald Corporation,* 37 BTA 922 (1938); *Southeastern Building Corporation,* 3 TC 381 (1944), affirmed 148 F. 2d 879 (C.A. 5th, 1945), certiorari denied 326 U.S. 740; *Bradley* vs. *C. I. R.,* 184 F. 2d 860.

The Commissioner also asserts that the decision of the Tax Court must be affirmed because petitioner is not entitled to convert ordinary income into capital gain through the depreciation deduction, and that section 117(j) of the Internal Revenue Code of 1939, which permitted capital gain upon the sale or exchange of certain property used in a trade or business, must be applied in such a manner that only a "reasonable allowance" for depreciation be deducted.

In his deficiency notice, the Commissioner stated: "It is further held that you were also in the business of selling used automobiles during the years 1950 and 1951. Consequently, the profit realized from the sale of the automobiles

was income from the sale of property held primarily for sale in the ordinary course of your business within the meaning of section 117(j) of the Internal Revenue Code and such income may not be treated as a capital gain under the above-mentioned section of the Code. * * *'' The Commissioner abandoned that issue in his brief filed with the Tax Court and conceded the right of petitioner, under section 117(j), to treat the sales of his automobiles as sales of property used in his trade or business, not held primarily for sale to customers in the ordinary course of business. The Commissioner's abandonment of this approach was probably influenced by the decision of *Philber Equipment Corp. vs. Commissioner of Internal Revenue, supra.* That case involved the same type of business in which petitioner engages and with similar disposal practices of automobiles. The court held, since the circumstances disclosed that the acquisition, use and disposition of taxpayer's vehicles was consistent with business purposes of vehicle rental, that his vehicles were not held primarily for sale to customers, and thus the gain from the sale of such vehicles was not ordinary income but was capital gain and was taxable as such.

The argument is not convincing in the light of the long-continued and consistent practice of the Commissioner outlined above, which led taxpayers to adopt a method of depreciation which the Commissioner now contends results in unreasonable deductions for depreciation, and the legislative history of section 117(j). In amending, in 1942, section 117 of the Internal Revenue Code of 1939 by adding sub-section (j), Congress extended to taxpayers who sold at a profit depreciable assets used in a trade or business, held for more than six months, and not held primarily for sale to customers in the ordinary course of business, the favorable treatment on such profits accorded to capital gains. The legislative history of section 117(j) shows that Congress has not receded from its original purpose. Con-

gress was aware of the Commissioner's contention that taxpayers were converting into capital gains ordinary income arising from unreasonable deductions for depreciation.

Congress and the Treasury Department were well aware of the losses in revenue occurring under section 117(j). The report of the Business Tax Section of the Division of Tax Research of the Treasury Department submitted to the Ways and Means Committee of the House of Representatives (see "Revenue Revisions," 1947-1948, hearings of December 2-12, 1947, Part 5, page 3756) contained warnings against revenue losses through the benefits of capital gain treatment of profits from sale of assets subject to accelerated depreciation, and recommended that if the taxpayer elects to use accelerated depreciation, gains to the extent of the excess of accelerated over normal depreciation should be treated as ordinary income. Congress took no action. In 1950 the Treasury Department recommended to Congress that losses on the sale of depreciable business assets be treated as capital rather than ordinary losses (see Committee Reports on HR-8920, 81st Congress, Second Session). Again Congress did not act. On April 19, 1954, the Committee on Federal Taxation of the American Institute of Accountants filed with the Senate Finance Committee its recommendation number 180, with respect to section 1231 of the proposed Internal Revenue Code of 1954, as follows: "Gain or loss of property used in the trade or business, etc.; should be treated uniformly as ordinary income or loss."[11] The recommendation was heard but not adopted.

In the Revenue Code of 1954, Congress limited capital gains on sales of emergency facilities amortized under section 168, but did not limit capital gains upon the sale of

[11] Hearings before the Committee on Finance, U.S. Senate, 83rd Congress, Second Session, on HR-8300, Part 3, page 1324.

assets used in a trade or business. The House report[12] states, with respect to section 1231, "This section is derived from section 117(j) of the present law. There is no substantive change intended but some rearrangement has been made."

The Commissioner contends that to define "useful life" as the physical or economic life of a depreciable asset does violence of the Congressional intent expressed in the basic statute that there shall be allowed as a deduction from gross income "a reasonable allowance for exhaustion, wear and tear * * * of property used in the trade or business * * *" and is contrary to the theory underlying such allowance that the yearly depreciation deduction reasonably reflect that portion of the value of the capital assets consumed in earning the gross income for the taxable year, citing *U. S. vs. Ludey*, 274 U.S. 295; *Virginia Hotel Co. vs. Helvering, Commissioner of Internal Revenue*, 319 U.S. 523; *Detroit Edison Co. v. Commissioner of Internal Revenue*, 319 U.S. 98.

Again, the Commissioner overlooks the force of his own regulations, his long-continued, consistent practice thereunder, and the Congressional intent expressed in the enactment and subsequent legislative history of section 117(j).

Finally, the Commissioner contends that the findings of fact of the Tax Court that the short term rental cars had a useful life of 17 months and the long term rental cars had a useful life of three years each, and that each car of each class had a value of $1,325 and $600 respectively, must be accepted by this Court unless clearly erroneous. Such findings are conclusions of law, legal inferences from the evidentiary facts or, in any event, determinations of ques-

[12] Page 275 of House Report No. 1337, 83rd Congress, Second Session.

tions of law and fact. They were arrived at by the application of erroneous concepts of the terms "useful life" and "salvage value". Under such circumstances we are not bound by the "clearly erroneous" rule. *Curtis* vs. *Commissioner of Internal Revenue*, 232 F. 2d 167; *Helvering* vs. *Tex-Penn Oil Co.*, 300 U.S. 481.

The decision of the Tax Court is reversed and the cause remanded to the Tax Court for further hearing and proceedings for the redetermination of the tax liability of petitioners in a manner consistent with the views expressed herein.

FILE COPY

No. [illegible]

In the Supreme Court of the United States

OCTOBER TERM, 1959

THE [illegible] CORPORATION, a Corporation (Successor by Merger to J. FRANK [illegible], INC., a Corporation), PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE UNITED STATES

J. LEE RANKIN,
Solicitor General,
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In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 283

THE HERTZ CORPORATION, a Corporation (Successor by Merger to J. FRANK CONNOR, INC., a Corporation), PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE UNITED STATES

Taxpayer is engaged in the business of renting and leasing automobiles and trucks which it owns. For the taxable years ended March 31, 1954, 1955, and 1956, it claimed accelerated depreciation allowances computed under the declining balance method provided for in Section 167(b)(2) of the Internal Revenue Code of 1954. Under Section 167(c) of the 1954 Code, however, the declining balance method of depreciation may not be used unless the assets being depreciated have a useful life of three years or more. The question pre-

sented is whether the term "useful life" as used in the statute means the period during which the assets are owned and used by the taxpayer, as the court below held, or whether it means the period during which the assets are usable for business purposes (the physical business life of the property), as taxpayer contends. An additional question is also presented with respect to trucks owned and used by the taxpayer which concededly had a useful life in excess of three years and were thus entitled to be depreciated under the declining balance method. As to these trucks, the question is whether depreciation may not be allowed below a reasonable salvage value and whether the Treasury Regulations so providing are valid, as the court below held, or whether the salvage value is the undepreciated balance remaining under the declining balance method, as the taxpayer contends.

We believe that the decision of the Court of Appeals is correct in all respects.[1] The question presented as to the meaning of the term "useful life", however, is essentially similar to that presented in *Evans* v. *Com-*

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[1] In addition, the decision of the court below on the issue of useful life may also be supported upon the ground that the District Court incorrectly held that the Regulations defining such term could not be retroactively applied to the taxable years here involved, which ended before the issuance of such Regulations. Even if it be assumed, contrary to the decision below, that such Regulations effected a change in the previously existing definition of the term "useful life", no question of their retroactive application was presented, for taxpayer did not claim the right to the accelerated depreciation here in question until after such Regulations had been promulgated, and in fact did so by filing amended returns under procedures established by such Regulations. Moreover, apart from the foregoing, the Regulations may properly be applied to taxable years governed by the 1954 Code, as here, even though ending prior to the issuance date. *Automobile Club* v. *Commissioner*, 353 U.S. 180; *Helvering* v. *Reynolds*, 313 U.S. 428.

missioner, 264 F. 2d 502 (C.A. 9th)), No. 143, this Term, in which the Commissioner has filed a petition for a writ of certiorari, and in *Massey Motors, Inc.* v. *United States*, 264 F. 2d 552 (C. A. 5th), No. 141, this Term, in which the taxpayer has filed a petition for a writ of certiorari. Under these circumstances the Government does not oppose the granting of certiorari here.

Though not opposing certiorari, we note that the question presented as to salvage value, while similar in broader outline, differs somewhat from that presented in the cases mentioned. In those cases the problem is one of application of the proper concepts of salvage value in computing depreciation under the straight line method. In the instant case, however, the problem presented is whether Treasury Regulations, which provide that in computing depreciation under the declining balance method no depreciation may be taken below a reasonable salvage value, are valid, as the court below correctly held, or whether the salvage value properly to be applied is the undepreciated balance remaining at the end of useful life. On this issue, the case is one of first impression and there is no conflict.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

SEPTEMBER, 1959.

U. S. GOVERNMENT PRINTING OFFICE: 1959 518787 283

FILE COPY

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Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

REPLY BRIEF FOR PETITIONER

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In the Supreme Court of the United States

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REPLY BRIEF FOR PETITIONER

Respondent, while not opposing the granting of certiorari herein, seeks to minimize the concession it makes as petitioner in *Evans* (No. 143, this Term) that these two cases present "the same basic issue . . . as to useful life and salvage value", with *Evans* presenting it under the 1939 Code and this case presenting it under the current 1954 Code (*Evans* petition, page 13). Respondent attempts to do so by now asserting that the question of salvage value, "while similar in broader outline, differs somewhat from that presented in the cases mentioned", by reason of which respondent asserts there is no conflict on this issue (Memorandum for the United States herein, page 3).

The government was correct in its concession in the *Evans* petition and may not recede from that concession. As pointed out in our petition (page 7), the difference in the way the question of salvage value arises is unimportant; for the government's position on the issue is the same in each case—namely, that the taxpayer in taking the depreciation is limited to "salvage value," which the government urges to be the estimated resale value of cars at the end of their useful life in the taxpayer's business. The conflicting results reached by the Ninth Circuit in *Evans* and the Third Circuit in this case thus produced not only the admitted conflict on the issue of useful life, but also produced a fundamental conflict on the issue of salvage value, which the government seeks to tie, and which is tied, inextricably to the concept of useful life.

As urged in our petition (pages 18-20), certiorari should be granted here in order to resolve this conflict on the important and continuing question of useful life and the interrelated issue of salvage value in terms of the current 1954 Code instead of dealing with it only in terms of the old 1939 Code.

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In the Supreme Court of the United States

OCTOBER TERM, 1959

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In the
Supreme Court of the United States

October Term, 1959

No. 283

THE HERTZ CORPORATION, a corporation (SUCCESSOR BY MERGER TO J. FRANK CONNOR, INC., a corporation),
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER.

OPINIONS BELOW.

The opinion of the Court of Appeals (R. 131-39) is reported at 268 F. 2d 604. The opinion of the District Court for the District of Delaware (R. 105-29) is reported at 165 F. Supp. 261.

JURISDICTION.

The judgment of the Court of Appeals was entered on July 6, 1959 (R. 139-40). The petition for a writ of certiorari was filed on August 6, 1959, and was granted on October 12, 1959. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

STATUTES AND REGULATIONS INVOLVED.

Subsections (a), (b), (c) and (f) of Section 167 of the 1954 Internal Revenue Code and the pertinent sections of the Treasury Regulations promulgated thereunder, together with Sections 1011, 1012, 1016 and 1231 of that Code, are set forth in Appendix A, *infra*, pages 105-108. Section 117(j) of the Internal Revenue Code of 1939 is set forth in Appendix A, *infra*, pages 108-109.

QUESTION PRESENTED.

Petitioner taxpayer is in the business of renting and leasing automobiles and trucks. Under Section 167(c) of the 1954 Internal Revenue Code, certain accelerated depreciation methods (including the double declining balance method under Section 167[b][2]) may be used only with respect to property "with a useful life of 3 years or more. . . ."

The question presented is whether petitioner, for its taxable years 1954, 1955 and 1956, may compute its depreciation allowance by using the double declining balance method authorized by Section 167(b)(2); and, specifically:

(1) Whether "useful life" means the physical or inherent functional life of petitioner's vehicles (*i.e.*, their life for general business purposes), as petitioner contends, rather than the period of use by petitioner in its particular business, as the court below held, and

(2) Whether the only salvage value limitation in the use of that method is the salvage value which is inherent in that method, as petitioner contends, rather than a salvage value which the new regulations purport to define as the

estimated resale value of petitioner's vehicles at the end of their use in its particular business, as the court below held.

STATEMENT.

The questions presented by this case arise from claims for refund of federal income taxes paid by the taxpayer for its fiscal years ended March 31, 1954, March 31, 1955 and March 31, 1956. These refund claims aggregate $14,561.12 and were filed for the following years and amounts:

Year Ended March 31	Income Tax
1954	$ 100.15
1955	4,044.54
1956	10,416.43
	$14,561.12

(R. 77-93).

The amounts claimed reflect the difference in tax resulting from the computation of depreciation of the taxpayer's automobiles and trucks by the declining balance method, pursuant to Section 167(b)(2) of the 1954 Code, rather than by the straight-line method employed by the taxpayer in its returns filed for the years in question. In order to be eligible for the declining balance method, Section 167(c) requires that the taxpayer's business vehicles must have a "useful life" of three years or more. It was uncontroverted in the courts below that taxpayer's automobiles had a total economic business life of four years.

The original taxpayer, J. Frank Connor, Inc., a New Jersey corporation, was merged into The Hertz Corpora-

tion, a Delaware corporation, on July 5, 1956 by statutory merger. Thus, Hertz became entitled to file the claims for refund of federal income tax involved here (R. 94, 95).

During the three taxable years involved, the taxpayer was engaged in Newark, New Jersey, in the business of renting and leasing automobiles and trucks without drivers. As used in this business, the term "renting" refers to the hiring of vehicles on a relatively short-term basis, at stipulated rates measured by mileage or by the hour or by the day (R. 37). Similarly, "leasing" refers to the contract hiring of vehicles for a fixed period on a relatively long-term basis (for example, by the year or longer period) (R. 37, 38).

At all times during these years, the taxpayer's vehicles were subject to a preventive maintenance program designed to keep them safe and mechanically in good condition. The influential factors in determining when the taxpayer sold vehicles and acquired new ones to maintain or expand its fleet included such considerations as the public demand for the taxpayer's services (R. 39), the activities of competitors (R. 40), mechanical changes and improvements in vehicles (R. 40), general and local business conditions (R. 41, 42), climatic and weather conditions (R. 41), war or peace (R. 41), industry-labor relations (R. 40, 41), the availability of new cars (R. 40, 41) and the taxpayer's immediate financial condition (R. 46). None of these factors was predictable in advance, and sales and purchases of automobiles did not necessarily accompany each other (R. 39, 42, 108, 110).

The percentage of the taxpayer's fleet which it could profitably operate was a factor in determining vehicle sales and purchases. A surplus of vehicles prompted dispositions, and an expanding demand for taxpayer's services stimulated acquisitions (R. 39). In this connection, the general level of the economy was important, as the taxpayer in large part relied on the patronage of commercial travelers (R. 41). Similarly, if local business conditions were depressed, the local demand for the taxpayer's vehicles would be affected, and surplus vehicles would be sold (R. 39, 41).

An example of the unpredictable influence of outside events on the demand for the taxpayer's vehicles was the impact of the opening of the Newark airport in 1951. Because of its out-of-the way location, the taxpayer failed to anticipate the ultimate increase in its fleet which the rental activity at the airport would stimulate. In 1952, when the airport closed because of aircraft crashes in the area, rentals from that source ceased entirely. When it reopened in 1954, the taxpayer in one year's time expanded its fleet by 40 to 60 cars as a result of the airport volume (R. 42).

Unexpected climatic conditions also influenced the taxpayer's fleet expansion. During an unusual period when telephone lines were down, one of the taxpayer's accounts, a telephone company, required for long periods a great number of cars, which the taxpayer supplied. It had to buy additional vehicles to continue to service its other business during the period, and this occasioned the expansion of the taxpayer's fleet (R. 41).

The preferences of the public and the activities of the taxpayer's competitors also influenced its decisions to buy

and sell cars. If competitors were renting certain types of automobiles which the public demanded, the taxpayer would have to stock these types to maintain its market position (R. 40). With the introduction of mechanical changes (such as automatic transmissions) for which there was a demand, the taxpayer had to supply automobiles which had such features, and at the same time it had to continue to keep cars with conventional transmissions available to satisfy customers preferring vehicles of this type (R. 40).

Strikes and labor disputes also affected the taxpayer's automobile purchases. For example, when truck carriers bringing new vehicles from the factory were on strike, the taxpayer was compelled to retain old vehicles months longer than it could have anticipated, before it could add new cars to its fleet (R. 40, 41).

In addition, the taxpayer's occasional pressing need for cash led to unpredicted, and undesired, sales of vehicles. At one time the taxpayer had to sell automobiles to meet a bank loan; another time this was necessary to pay off finance notes; and sales were once made in order to pay rent (R. 46).

Under the influence of these factors, the periods during which the taxpayer held automobiles and trucks used in its renting and leasing business showed substantial variations, not only during the taxable years under review, but also throughout the nine-year history of its separate business existence. The following table, introduced in evidence in the District Court (Plaintiff's Ex. 2, R. 48), gives holding period information for the vehicles sold in each year and indicates this wide variation:

	Year Ended March 31	No. of Vehicles	Holding Period In Months Average	Longest	Shortest
Cars	1948	20	52	81	31
	1949	6	26	45	19
	1950	27	26	69	17
	1951	13	27	29	24
	1952	24	34	52	30
	1953	25	26	35	24
	1954	28	32	67	21
	1955	12	30	39	23
	1956	66	23	51	16
Trucks	1948	6	73	90	35
	1949	4	34	79	17
	1950	12	53	101	34
	1951	18	49	71	34
	1952	14	47	57	36
	1953	14	50	60	11
	1954	5	23	24	21
	1955	4	45	51	32
	1956	9	45	85	10

The average holding period of the cars sold during the three fiscal years ended March 31, 1954, 1955 and 1956 was 26.17 months; the average holding period of cars sold during the entire nine-year period was 29.36 months. But cars sold in fiscal 1948 were held as long as 81 months; cars sold in fiscal 1954 were held as long as 67 months; and cars sold in fiscal 1956 were held as long as 51 months.

The average holding period of trucks sold during the three years in question was 38.89 months; the average

holding period of trucks sold during the entire nine-year period was 48.26 months. Some trucks were held, however, for much longer periods—as long as 101 months for trucks sold in fiscal 1950, and 85 months for trucks sold in fiscal 1956.[5] (All average figures were computed on a weighted basis—giving effect to the number of cars sold in each year.)

Certified public accountants—partners, respectively, in the firms of Ernst & Ernst, Price Waterhouse & Company and Arthur Andersen & Company—testified that the term "useful life" has consistently meant and still means the full economic or business life of an asset, no matter how many taxpayers may hold the asset, and not the period an asset is held by a particular taxpayer, a period which automatically cuts off if the taxpayer sells the asset before the end of that asset's business life. They also testified that the useful life of automobiles used for business purposes is four years (R. 29, 33, 63).

One of the accountants, Mr. Donald J. Erickson, of Arthur Andersen & Company, testified further, from his many years of experience as an accountant in the rent a car field, to these specific facts:

1. That in the case of a taxpayer in the car and truck renting and leasing business who acquires all of the vehicles new which it uses in its business, which rents cars and trucks without drivers for short periods of time and, to a lesser extent, leases some cars and trucks without drivers on a long term basis for periods ranging from one to two years, whose automobiles are used either for pleasure or for business, whose vehicles

receive regular preventive maintenance care—his advice, as an accounting expert in this industry, would be to use, for depreciation purposes, a useful life of four years.

2. That his advice would not be changed by reason of the fact that the taxpayer disposed of some or all of the vehicles before the expiration of such four-year term.

3. That his advice would be the same although it were shown that annually there were changes in the style or design of vehicles, or that there were from time to time mechanical innovations such as power steering or automatic transmission (R. 60-64).

Mr. Walter L. Jacobs, President of The Hertz Corporation, who has been active in the rent a car industry for forty years, testified as to the nature of the industry in general and the business of The Hertz Corporation in particular. He characterized the industry as a young business still in its formative stages. Along with the greater rapidity of the industry's growth since World War II, competition has increased and important business policies in the industry have of necessity been forced to remain flexible and responsive to changing business conditions (R. 51, 52).

He stated that The Hertz Corporation owns and operates a rent a car business in some 170 cities, and licensees operate in some 650 other cities (R. 51). He reviewed the business conditions faced by Hertz and the considerations governing its purchases and sales of automobiles. These factors were present with respect to all businesses

in the industry, including that of the taxpayer during the years in question (R. 55). In this connection, he stated that fleet newness was far from the sole factor influencing acquisitions and would be disregarded if economic conditions warranted (R. 57, 58). Among the important other factors influencing vehicle acquisition and disposition which he enumerated were:

— General economic conditions: With a recession sales would exceed purchases as surplus cars were disposed of; prosperity would stimulate acquisitions (R. 52);

— The state of the used car market: If depressed, it can inhibit acquisitions, since funds obtained from sales are often needed to finance replacement vehicles R. 52);

— New competition: Entrants into the industry start with new automobiles, putting competitive pressure on the older operators to make early fleet replacements (R. 52);

— Wars: The unavailability of new cars during World War II compelled Hertz to retain its cars as long as seven years, and involved unusual and expensive maintenance efforts (R. 53);

— Mechanical innovations: The introduction of automatic transmissions, power steering and power brakes have encouraged fleet replacements (R. 53);

— Labor disputes: Strikes can seriously affect acquisition policies; for example, a General Motors strike of considerable duration had a marked effect (R. 53);

—Advent of the small car: The demand for small cars, which is yet uncertain, will create a serious problem—that of trying to dispose of high-cost cars in order to introduce small cars into the fleet without a substantial loss (R. 53, 54).

None of these factors bearing on the sale and purchase of cars by The Hertz Corporation is predictable (R. 54). Hertz does not know when it will sell the cars that it presently owns (R. 54).

Mr. Jacobs further testified that, as a practical matter, it is uneconomic to use an automobile for business purposes for a period longer than four years. (R. 56). The Hertz Corporation, as well as the majority of the Hertz System licensees, uses a four-year useful life for the purpose of depreciating its automobiles (R. 56).

The taxpayer duly paid all taxes shown on its returns filed for the taxable years ended March 31, 1954, 1955 and 1956 (R. 95, 96). Its return for the taxable year ended March 31, 1955 was examined by the Internal Revenue Service office at Newark, New Jersey, and approved as filed, except for a minor adjustment not relevant here; that return showed and claimed depreciation deductions on the basis of a four-year useful life for automobiles, a five-year useful life for vans and heavy-duty trucks and a four-year useful life for other trucks (R. 19, 49).

In the refund claims hereinabove described, the taxpayer computed depreciation on the declining balance method with respect to the automobiles and trucks involved, using a rate of 200% of the straight-line rate in

lieu of the depreciation deductions claimed in the taxpayer's income tax returns. The Commissioner of Internal Revenue took no action on these claims for six months, and the present suit for refund was filed in the District Court for the District of Delaware.

The District Court in its opinion found the facts, on the basis of the testimony and exhibits, substantially as set forth above (165 F. Supp. 266; R. 112).

Among the findings of fact so made was the following:

> "Over the years, 'useful life' has come to be regarded in the field of business and accounting to mean the business life of an asset regardless of whether it passed from one owner to another. Useful life was meant to be the total life for which the asset was useful for business purposes. Not only was this the general accounting understanding of the concept of useful life, but the uncontradicted testimony of expert certified public accountants was that prior to the promulgation by the Commissioner of Internal Revenue of his 1956 regulations on depreciation, their experience with representatives of the Internal Revenue Service was always that the depreciation rate was computed on the basis of the aggregate business life, regardless of changes in the ownership of the asset." (165 F. Supp. at 265; R. 110.)

The District Court rendered judgment for the taxpayer, holding that in 1954, and for many years before, the term "useful life" had come to mean the entire physical life of the asset for business purposes, but that Congress, in enacting the 1954 Code, intended to change that meaning.

that the term "useful life", as changed in meaning by that Code, now means the period of use of an asset in the hands of a particular taxpayer; that Reg. Sec. 1.167(a)-1(b) of the Treasury Regulations, issued in 1956, defining the term "useful life" to mean the period during which the asset may reasonably be expected to be used by a given taxpayer, was valid; that the Commissioner, before issuing the depreciation regulations of 1956, had acquiesced in the construction of the term "useful life" as used in business and accounting circles, to mean the physical business life of the asset; that the regulations could not be applied retroactively to the three taxable years here involved; and that, therefore, the taxpayer was entitled to compute depreciation under the declining balance method (R. 116, 120, 125, 127, 129).

The Commissioner conceded in the District Court that even under his definition of "useful life", the taxpayer's trucks had a life of more than three years, and that the taxpayer was entitled to use double declining balance depreciation on those items. The Commissioner contended, however, that under Reg. Sec. 1.167(a)-1(a) and (c) and 1.167(b)-2(a) of the regulations these trucks could not be depreciated below an imposed salvage value, the estimated sales value after the period of use. The District Court disagreed, holding that salvage value is inherent in the double declining balance method of depreciation, and that the legislative history of the depreciation provisions of the 1954 Code demonstrated that no other adjustment for salvage value was to be considered in computing depreciation under that declining balance method (R. 128).

The Court of Appeals for the Third Circuit reversed the District Court's judgment, holding (a) that "useful life" for depreciation purposes, as used under the 1939 Code and in Section 167 of the 1954 Code, means the period during which property is used by a particular taxpayer, and not the physical or economic life of the property, and (b) that an imposed salvage value (that is, a salvage value other than that inherent in the method) is to be applied as a further limitation on depreciation under the declining balance method provided for in Section 167(b)(2) of the 1954 Code (R. 138, 139).

SUMMARY OF ARGUMENT.

At the time Congress enacted Section 167 of the 1954 Code, in which the term "useful life" first appeared in the depreciation provisions of the tax law, that term had come to mean and had been understood by taxpayers, the Internal Revenue Service, the courts, lawyers, accountants and Congress to mean the physical or inherent functional life of the depreciable property (*i.e.*, the life of the property for general business purposes). This meaning of the term "useful life" was developed from the beginning through the practical administration of the depreciation provisions of the tax law as confirmed and reinforced by decisions of the courts and the public pronouncements of the Commissioner, and as shown by the uncontroverted testimony of the plaintiff's expert witnesses.

The legislative history of Section 167 of the 1954 Code—Congressional hearings, committee reports and floor debates—establishes conclusively that Congress did not in-

tend to change the meaning of "useful life" when it used that term for the first time in the depreciation provisions of the tax law. Rather, Congress clearly intended that term to have its common, usually understood meaning, the well defined meaning in the accounting and business world —physical or inherent functional life. Indeed, if Congress had intended a change from the established and traditionally accepted meaning it would certainly have added to Section 167 qualifying language of its own, such as "limited by the use of the asset by the taxpayer."

The Government in this case is attempting to assert a new administrative definition of "useful life" (issued after the close of the last of the three taxable years here involved) which, when combined with its misapplication of a superimposed salvage value to the double declining balance method, will result in a disallowance to taxpayers of capital gains upon the sale of business assets. For although this case is in form a technical dispute about depreciation, it is, in substance, another of the Treasury Department's continuing—and thus far unsuccessful—attempts to limit, without Congressional sanction, the application of Section 1231 of the 1954 Code, which imposes capital gain, rather than ordinary, taxation on gain arising from the sale of depreciable business property held for more than six months. The latest and perhaps the last move by the Treasury—a belated recognition that legislation is the proper solution—was made on January 18, 1960 in the President's budget message, which contains a specific recommendation to Congress to limit capital gains treatment of sales of depreciable property.

The Commissioner is also using this case to test his unsupported theory that salvage value should represent a dollar limit on the amount of depreciation allowable under the double declining balance method. But Congress regarded the very operation of the double declining balance method as providing for a "built-in" salvage for depreciable assets. Since the rate of depreciation under this method (which is always constant) is applied to an annually decreasing basis, there will always be at the end of the asset's useful life an unrecovered amount which represents the salvage value of the asset. The Commissioner's theory is without Congressional support. Congress predicated its legislative design upon the established understanding of useful life and salvage value, and expressly concluded that under the double declining balance method the salvage value is the inevitable undepreciated balance remaining at the expiration of the asset's useful life. Senate Report No. 1622, 83rd Cong., 2nd Sess., page 201 (3 U.S.C. Cong. & Adm. News [1954] 4836).

The Commissioner is attempting to shift basic depreciation standards on an *ad hoc* basis in order to maximize revenue. He is attempting to put into the depreciation standards extraneous concepts, such as holding periods and future market prices, which are contrary to the established statutory and accounting standards for determining depreciation—wear, tear and exhaustion. His attempt is creating additional uncertainty for taxpayers situated as is the plaintiff, whose holding periods are unpredictable because of circumstances beyond its control. He is attempting to thwart Congressional policy for liberalizing

the depreciation allowance as a stimulus to the economy. He is attempting to deny capital gains benefits which Congress has steadfastly retained.

Such results should not be allowed without the clearest expression of Congressional intent compelling those results, and are especially unjustified where, as here, all the relevant aids to construction point to the fact that Congress intended exactly the opposite. The Commissioner's recourse is legislation, not litigation.

If this Court should hold that the Commissioner's new definitions are valid, they nevertheless can be only prospective in application. The Commissioner's new definitions cannot be applicable prior to June 11, 1956, the day the regulations were first promulgated. A regulation containing a substantive change from a prior regulation which was issued under the same or similar statutory authority may not be given retroactive effect. *Helvering* v. *Griffiths*, 318 U.S. 371, 397 (1943).

ARGUMENT.

I.

AT THE TIME OF THE ENACTMENT OF SECTION 167(c) OF THE 1954 CODE, THE ESTABLISHED MEANING OF THE TERM "USEFUL LIFE" FOR FEDERAL INCOME TAX DEPRECIATION PURPOSES WAS, AND IT STILL IS, THE LIFE OF THE ASSET FOR GENERAL BUSINESS PURPOSES, BY WHOMEVER USED, AND NOT A SHORTER PERIOD DURING WHICH A TAXPAYER MAY HAPPEN TO HOLD SUCH ASSET.

The taxpayer in this case asserts its right under Section 167(b)(2) of the 1954 Code to take depreciation on automobiles used in its car renting and leasing business by using the double declining balance method—twice the rate permitted each year under the straight-line method, applied in the first year to the full cost, but thereafter to the declining balance remaining after the deduction of each year's depreciation, and further asserts that it is not limited to the straight-line method (an equal percentage of cost each year throughout the useful life of the asset).

The double declining balance method is open to the taxpayer in this case only if the assets in question—automobiles—have a "useful life" of three years or more (Section 167(c), 1954 Code, Appendix A, *infra*, page 106).

Thus, the basic issue for decision is whether "useful life", within the meaning of the depreciation statute, is the

life of an asset for general business purposes, by whomever used, as the taxpayer contends, or a shorter period during which a taxpayer may happen to hold such asset, as the Government now claims.

As a prelude to consideration of that question of law, we believe it essential to focus briefly on the uncontradicted evidence:

The only testimony in this case is that the "useful life" of automobiles used for business purposes—and, more particularly, the useful life of automobiles used in the car leasing and renting business—is four years (R. 29, 33, 42, 49, 56, 63); that the useful life of the automobiles used in the business of this taxpayer was four years (R. 42, 44); and that this taxpayer's income tax return for the fiscal year ended March 31, 1955, the second of the three years involved in this case (including, as it did, a four-year life for this taxpayer's automobiles), was reviewed by the Internal Revenue Service and was accepted as filed, except for a minor adjustment in administrative expense not pertinent here (R. 49).

The President of The Hertz Corporation, with forty years' experience in the vehicle renting and leasing business, testified that The Hertz Corporation has always used a four-year life for its automobiles (R. 56). Certified public accountant Donald J. Erickson, of Arthur Andersen & Co., testified that businesses in many lines (including the rent a car business) whose gross sales totaled about five

billion dollars in the aggregate and whose accounting practices were reviewed under his supervision, used a four year life preponderantly for their automobiles (R. 64). He testified further that the four-year useful life applied whether the automobiles were retained by the taxpayer for four full years or not (R. 63), as did several other witnesses (R. 29, 33, 56). Cross-examination failed to elicit anything in this connection except further confirmation of the use of the four-year life—by businesses in general and by this taxpayer—for automobiles used in business. No witness was offered by the Government to counter any of this testimony. It stands in the record uncontradicted, and was incorporated in the findings of fact made by the District Court (R. 112).

In this posture of the case, the Government, the plaintiff and the Court of Appeals agreed that the 1954 Code provisions in Section 167 with respect to depreciation were not intended to effect any change in existing law, except as to the methods of depreciation permitted to be utilized. However, the Government argued and the Court of Appeals held that the pre-1954 meaning of "useful life" was an estimate of the period that the asset would be used by the particular taxpayer (R. 138), while the plaintiff contends that the meaning was the inherent business life of the asset.

Therefore, the first question which the Court must resolve on this branch of the argument is: At the time of enactment of the 1954 Code, what was the existing law as to the meaning of useful life?

A. Useful life for federal income tax depreciation purposes has consistently meant the physical or inherent functional life of the property (i.e., the life of the property for general business purposes) and not the period during which it is estimated the taxpayer may hold the property.

At the time of enactment of the 1954 Code, judicial interpretation, administrative practices and pronouncements under the 1939 Code and prior revenue acts and expert opinion had long agreed that for purposes of the depreciation deduction "useful life" means the period during which an asset is physically useful for business purposes, rather than the shorter period during which it happens to be owned by a particular taxpayer.

If it were the latter instead of the former, contradictory and confusing results would ensue. For example, let us consider the case of two taxpayers who are in the same type of business and who buy—at the same time and at the same price—an identical asset. (Let us assume also the same degree of physical usage and wear and tear, and the same inspection and repair procedures.) Similarly, suppose that the two taxpayers accurately estimate their holding periods differently—all else being the same.

Under the Government's definition of useful life, depreciation will be computed differently for the two taxpayers in the above example, despite the fact that the assets involved will be undergoing exactly the same rate of "exhaustion, wear and tear" contemplated by the statute. Thus, the underlying statutory definition of depreciation would be changed from "exhaustion, wear and

tear" to something indeterminate—some combination of exhaustion, wear and tear and other considerations foreign to and unconnected with the wearing out of the assets and the direction of the statute.

Indeed, the plaintiff's definition is the one which, as we shall show, the Commissioner himself has supported and argued for in briefs filed both before and after the Commissioner's adoption of his new interpretation in the 1956 regulations.

1. *The prior cases.*

The principle that "useful life" means the business life of the asset itself, and not the period such asset is held by a specific taxpayer, has long been recognized by the courts.

In *Sanford Cotton Mills*, 14 B.T.A. 1210 (1929), Acq. X-2 CB 63, the taxpayer, a manufacturer of cotton sheeting, contested the Commissioner's reduction of the rate of depreciation of motor trucks from 33-1/3% (three-year life) to 20% (five-year life). The taxpayer made a practice of keeping the trucks approximately 2½ years. The Board of Tax Appeals nevertheless held that a rate of 25% (four-year life) was reasonable.

In *Merkle Broom Co.*, 3 B.T.A. 1084 (1926), Acq. V-2 CB 2, which concerned the proper depreciation rate for the taxpayer's fleet of automobiles used by its salesmen, the taxpayer claimed 33-1/3% per annum (three-year life) and the Commissioner allowed 20% per annum (five-year life). Although the Board of Tax Appeals found that the taxpayer renewed its fleet every second year, it nevertheless held that the proper rate for depreciation was 25% (four-year life).

In *Max Kurtz, et al.*, 8 B.T.A. 679 (1927), Acq. VII-1 CB 18, the taxpayer contested the Commissioner's determination of a five-year useful life for business automobiles and trucks which the Board of Tax Appeals found were traded in by the taxpayer after two or three years of use. Yet the Board held:

> "The Board is of the opinion that, upon consideration of all the evidence, the Commissioner's allowance for exhaustion, wear and tear of automobiles at the rate of 20 per cent per annum was reasonable." (8 B.T.A. at 683.)

The Commissioner officially acquiesced in these decisions.

In *General Securities Co.*, B.T.A. Memo, CCH Dec. 12,-500-D (1942), *aff'd per curiam* on another issue, 137 F. 2d 201 (6th Cir. 1943), the facts with respect to the depreciation issue were found by the Board of Tax Appeals as follows:

> "In its business petitioner used one or two automobiles in which its agents traveled over territory located in all of the southern states. Each automobile traveled some 60,000 to 75,000 miles a year. *Petitioner kept his automobiles from one to two years.* When Petitioner traded its cars in after one year, from a value standpoint, they had a third to a half of their original value left. *The normal useful life of automobiles used by petitioner in its business was three years.*" (B.T.A. Memo, CCH Dec. 12,500-D at 37,941; emphasis added.)

The Commissioner in that case was contending for a longer useful life for petitioner's automobiles than the three years used by petitioner in computing its depreciation.

Neither the parties nor the Board of Tax Appeals considered it proper to equate the automobiles' useful life with the taxpayer's one- or two-year period of ownership.

In fact, it is significant that in each of the foregoing cases the Commissioner took the position that the useful life of the automobiles was a period substantially longer than the taxpayer's holding period.

Other cases which similarly illustrate the traditional distinction between an asset's useful life and the periods during which it happens to be used by a particular taxpayer in his business are: *West Virginia & Pennsylvania Coal & Coke Co.*, 1 B.T.A. 790, 792 (1925); *J. R. James*, 2 B.T.A. 1071, 1072 (1925), Acq. V-1 CB 3; *Wallace G. Kay*, 10 B.T.A. 534, 535 (1928), Acq. VII-1 CB 17; *W. N. Foster, et al.*, 2 TCM 595, 597 (1943); *John A. Maguire Estate, Ltd.*, 17 B.T.A. 394, 399 (1929), Acq. IX-1 CB 34; *Nat Lewis*, 13 TCM 1167, 1170 (1954); *Whitman-Douglas Co.*, 8 B.T.A. 694, 697 (1927); and *Cohen* v. *Lowe, Collector*, 234 Fed. 474, 476 (D.C.S.D.N.Y., 1916).[1]

The Court of Appeals below took the position (R. 136) that these cases were of little, if any, use as precedents, because the issue was not squarely presented nor was any theory of useful life presented. The Court of Appeals was mistaken. The proper meaning of useful life was

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[1] In the last-cited case, the court stated, at page 476:

"[The depreciation allowance] is to be based upon the life of the building, in the sense of the number of years the building would remain in a condition to be habitable for the uses for which it was constructed and used. . . ."

fundamental to the decision in each of those cases, since the question in each case was the proper depreciation deduction. For this purpose it was necessary to know the useful life, and this was determined in terms of how long the asset would last.[2]

The Court of Appeals below relied (R. 138) upon the following single sentence in *United States* v. *Ludey*, 274 U.S. 295, 300-301 (1927):

> "The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost."

That statement was unnecessary in the determination of the case. All that *Ludey* decided was that the deductions for depreciation and depletion to which the taxpayer was entitled should be subtracted from original cost in determining the basis of certain oil properties at the time of

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[2] This is borne out by an examination of the underlying briefs and records. For example, in *Max Kurtz, et al.*, 8 B.T.A. 679 (1927), Acq. VII-1 CB 18, the transcript of testimony (pages 41-43) shows questioning directed to finding out "How long [the] equipment would last under [given] conditions"; in *Sanford Cotton Mills*, 14 B.T.A. 1210 (1929), Acq. X-2 CB 63, the petitioner's brief (pages 6-7) squarely posed the question of how long the automobiles would "last."

It should also be noted that in a number of the cases cited above, the Commissioner has officially acquiesced in decisions which defined useful life for depreciation purposes as meaning the business life of the asset irrespective of the taxpayer's holding period.

sale. There was no dispute as to the method of depreciation or depletion (274 U.S. at 297). The sole dispute—a dispute far removed from the issues at bar—was whether uncontroverted amounts of depreciation and depletion had to be deducted from cost in computing gain or loss on sale of the taxpayer's oil properties. A number of the cases cited above were decided after the decision in *Ludey*, and, indeed, the Commissioner acquiesced in a number of those cases.

2. *Recent decisions.*

Philber Equipment Corporation v. *Commissioner*, 237 F. 2d 129 (3d Cir. 1956), provides judicial corroboration (as well as the Commissioner's own admission) of the position that a taxpayer's holding period of leased vehicles (trucks, trailers and tractors) does not determine their useful life. There, the taxpayer regularly disposed of such vehicles after the end of one-year terms during which they were leased to taxpayer's customers. The court stated:

> "Taxpayer knew that when equipment was purchased, it would probably be able to rent the equipment for a *period substantially less than its useful life*, and sale of the equipment would follow expiration of a lease." (237 F. 2d at 130; emphasis added.)

And the Commissioner specifically argued to the same effect in his brief, where he stated:

> "Because of existing conditions taxpayer knew when it purchased equipment that it would likely be able to rent such equipment only for a *period that was substantially less than its useful life.*" (Brief for Re-

-spondent, p. 5, *Philber Equipment Corporation* v. *Commissioner of Internal Revenue*, (3d Cir.), Docket No. 11,860; emphasis added.)

And again, at page 11 of the Commissioner's brief in that case, he stated:

> "... all of the leases involved were only for a one-year term, *a period substantially less than the useful life* of this type of equipment as its resale in the tax years and re-lease in later years demonstrates." (Emphasis added.)

Here is a clear recognition by the Commissioner, in 1956, of the accepted meaning of useful life, directly contradicting defendant's position in the case at bar.

We refer the Court also to *Pilot Freight Carriers, Inc.*, 15 TCM 1027 (1956), in which the taxpayer's tractors and trailers were shown to have been held by the taxpayer for average periods of 38 months and 32.6 months, respectively. Nonetheless, the court held that the useful lives of such tractors and trailers, for depreciation purposes, were, respectively, four years (instead of 38 months) and five years (instead of 32.6 months). Despite the holding periods shown, the Commissioner had actually *asserted and was contending for deficiencies* on the basis of *five- and six-year useful lives, respectively.*[3]

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[3] The briefs in *Pilot Freight Carriers* (which was decided *after* promulgation of the 1956 depreciation regulations here involved) show an explicit submission to the Tax Court of the conflicting views of the meaning of useful life. (See Commissioner's brief, Docket No. 53266, pages 29-30.)

Thus, in a parade of litigated cases over the years there has been implicit in the Commissioner's position—and very frequently he has been most explicit about it—the proposition that useful life means economic physical life, not just a given taxpayer's period of use. In those cases, the Commissioner has given the word "useful" its actual meaning of "able to be used," "fit to be used," or "capable of use", rather than any strained and unsupported definition such as "retained for use", "held for use", or "still usable but not yet sold or otherwise disposed of." In those cases, he has apparently recognized also that the word "life" is far less consistent with any concept of holding period than it is with viable existence. "Life" is something which ends in death, or disintegration or at least absence of *usefulness*—not something which ends with a transfer to other hands for still further use. "Useful life" means today exactly what it has always meant—except for a 1956 Treasury regulation which tries to engraft a new and inconsistent meaning on a well-understood phrase.

Evans v. *Commissioner of Internal Revenue*, 264 F. 2d 502 (9th Cir., 1959), No. 143, this Term, certiorari granted, October 12, 1959, fully supports the plaintiff's position.

In addition, recent decisions of the United States District Court for the Southern District of Florida and the Tax Court confirm in all respects the plaintiff's view of useful life—*Davidson* v. *Tomlinson*, 165 F. Supp. 455 (D.C. S.D. Fla. 1958), and *Lynch-Davidson Motors, Inc.* v. *Tomlinson*, 172 F. Supp. 101 (D.C.S.D. Fla. 1958), both on appeal to the Fifth Circuit.

In *Charlie Hillard*, 31 T.C. 961 (1959), also on appeal to the Fifth Circuit, the Tax Court confirms plaintiff's view of the meaning of useful life under the 1939 Code. There, the taxpayer was in the rent-a-car business. On the issue of depreciation allowable for periods during which taxpayer's automobiles were held for rental purposes, Judge Raum stated:

> "Petitioner, in his returns, originally treated the rental cars as having a normal useful life of *3 years;* and the Commissioner's determination, agreed to by petitioner, fixed that period at *4 years. Yet, it was petitioner's practice to sell the cars after they had been in use for only about a year.* Thus, when he purchased the cars in the first instance it was plainly his intention to use them in the rent-a-car operation *for a comparatively minor portion of their useful life and then to sell them.*" (31 T.C. at 969; emphasis added.)

We note two things about this case: First, despite the fact that taxpayer sold the cars after they had been in use only about a year, not only did the Commissioner fail to contend that their useful life was a year, but he actually *extended* the claimed three-year life to four years (which, we note, is the only useful life for automobiles sustained by the record in the instant case); and, second, the Tax Court noted, as did the Third Circuit in the *Philber* case, that the holding period of the vehicles was only a small part of their useful life.

Thus, decisions from 1916 to 1959 have declared that "useful life" has meant and means the full physical life of an asset and not the period during which it is held by one taxpayer.

The Fifth Circuit's recent non-unanimous decision in *United States* v. *Massey Motors, Inc.*, 264 F. 2d 552 (5th Cir. 1959), No. 141 this Term, certiorari granted October 12, 1959, is plainly distinguishable on the facts, and is, moreover, erroneous in its statement of the governing legal principles, for the following reasons:

(i) The plaintiff in that case was a new car dealer who "temporarily assigned" new cars for use as executive cars and rental cars. The court referred to the cars as "bought by him for sale but temporarily assigned for use in the business", pointed out that the executive cars in issue were sold for $11,272.80 more than their cost and the rental cars in issue for $525.84 more than their cost, and added that "it is quite doubtful that Congress ever intended that automobiles temporarily used by people in the business of selling automobiles should be subject to depreciation at all". The Fifth Circuit was simply using the depreciation provisions to eliminate what it regarded, on the facts, as a loophole under Section 117(j) of the 1939 Code. But in the case at bar, plaintiff was not a dealer, did not temporarily assign vehicles to rental duty, and certainly did not, at the conclusion of the lease or rental cycle, sell them for more than it paid for them.

(ii) The Fifth Circuit expressed disappointment (footnote 1 to its opinion) with the Government's concession that the plaintiff was not a "dealer" within the meaning of Section 117(j), and then proceeded to repair the damage by its depreciation decision.

(iii) The Fifth Circuit refers to a special line of cases involving automobile dealers, including *Johnson-McReynolds Chevrolet Corporation*, 27 T.C. 300 (1956); *W. R. Stephens Co.* v. *Commissioner of In-*

ternal Revenue, 199 F. 2d 665 (8th Cir. 1952); and *Latimer-Looney Chevrolet, Inc.*, 19 T.C. 120 (1952). The facts in those dealer cases are far removed from those in the instant case, as the Commissioner has himself recognized in Rev. Rul. 54-229, 1954-1 CB 124, discussed below at pages 37-38, to which we direct the Court's special attention, and Rev. Rul. 60-15, I.R.B. 1960-3, 9.

(iv) The Fifth Circuit refers to the Commissioner's defeat on the capital gains issue in some of the automobile dealer cases, and states:

> "When he [the Commissioner] lost that argument he then issued new regulations which do precisely cover this type of property as used here. In doing so he did not intend to and did not—he *could* not—change the law. For us to hold that the new regulations of 1956 had the effect of defining useful life as useful life in the business for the first time would amount to our saying that the Commissioner could by Regulations change the law." (264 F. 2d at 559.)

Not only is the Fifth Circuit's opinion devoid of any real argument or citation to support this conclusion but the conclusion itself appears to us to reduce to this syllogism:

a. We cannot uphold regulations which change the law.

b. We are upholding these regulations.

c. Therefore, these regulations do not change the law.

3. *The Commissioner's own pronouncements.*

Nowhere in the Commissioner's pronouncements before he issued the 1956 depreciation regulations has he indicated the result for which he now contends. Instead, his pronouncements were entirely consistent with the plaintiff's contention and with what taxpayers generally have assumed is useful life for depreciation purposes, namely, general life for business purposes.

Thus, in O.D. 845, 4 CB 178 (1921) (still in full force and unmodified), the Treasury Department took the position that the term "useful life" means "the period of time over which an asset *may be used* for the purpose for which it was acquired. In the case of a new building, this period starts at the time the building is completed and *capable of being used.*" (Emphasis added.) It should be noted that there are no words of limitation and that this interpretation is in terms of the usability of the asset itself for general business purposes, without consideration of whether the particular taxpayer uses it up himself or sells it before the end of such usability. Not only does "useful life" begin when the building is first "capable of being used," but, likewise, its useful life ends when the building no longer "may be used."

The Government introduced in evidence (Defendant's Ex. 1A and 1B; R. 46) Bulletin "F", revised January, 1942, a bulletin issued by the Treasury Department, reciting on its title page that it contains information and statistical data relating to the determination of deductions for depreciation " . . . from which taxpayers and their counsel may obtain the best available indication of Bureau practice and the trend and tendency of official opinion in the administration of pertinent provisions of the Internal Revenue Code. . . . "

For many years before the taxable years here under review, the Treasury Department's Bulletin "F" has stated as the first portion of its Introduction:

> "The Federal income tax in general is based upon net income of a specified period designated as the taxable year. The production of net income usually involves the use of capital assets *which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption* usually is gradual, extending over a period of years. *It is ordinarily called depreciation, and the period over which it extends is the normal useful life of the asset.*" (Emphasis added.)

Bulletin "F" contains estimated useful lives and rates of depreciation. The title page states that the useful lives shown therein ". . . are set forth solely as a guide or starting point from which correct rates may be determined in the light of the experience of the property under consideration and all other pertinent evidence." In Bulletin "F", the Treasury Department informs taxpayers (page 52) that the estimated useful life of automobiles which are "used by commercial enterprises other than public utility and construction"[4] is five years for passenger automobiles

[4] The special classification in Bulletin "F" (page 29) for automobiles used in the construction industry (light—two years, medium—three years, heavy—five years) is a significant variation from the standard three- and five-year lives for automobiles generally, by reason of the introduction to the table of useful lives in the construction industry, which clearly underlines the physical basis of the useful life concept by stating (page 28):

> "Ordinarily, the physical property used by contractors in construction has relatively short lives, due to hard usage and, often, general lack of upkeep during rush jobs."

and three years for automobiles used by salesmen. Since plaintiff's automobiles were rented and leased for both purposes, the reasonableness of a four-year useful life is sustained by the Commissioner himself. And, we emphasize, Bulletin "F" makes it clear that although such averages "are not prescribed for use in any particular case", they are a starting point from which correct rates may be determined.

Thus, if testimony to the contrary had been offered, the *prima facie* showing made in Bulletin "F" might perhaps have been overcome. But the only testimony in the record is wholly consistent with Bulletin "F", *i.e.*, that automobiles used in the car rental or car leasing business have a useful life of four years.

We do not believe it plausible that when the Commissioner listed in Bulletin "F" (page 52): "Trucks: . . . medium—6 years; Heavy—8 years", he meant that a medium truck would be *kept and used by a given taxpayer* for six years, but a heavy truck would be used by that taxpayer for eight years. Did he not unquestionably mean that though it would be almost impossible to foretell when a taxpayer might decide, perhaps for reasons wholly unconnected with the condition of the truck, to sell it to a neighbor or trade it in on a new one, it was feasible to say that a medium truck, whether in one taxpayer's or a half dozen taxpayers' hands, has a *life* of approximately six years, whereas a heavy truck has a *life* of approximately eight years?

In the official reprint of Bulletin "F" in 1955 (IRS Publication Number 173), which reprinted tables of useful lives exactly as in the January, 1942 revision of Bulletin "F", appeared the statement that taxpayers should understand that "the useful lives shown are not mandatory" and that "taxpayers may determine reasonable periods of useful life for their depreciable property. . . ." but that the periods of estimated useful life used by taxpayers are subject to review by the Internal Revenue Service, and taxpayers should be prepared to substantiate the period so used.

Also in 1955 (IRB 1955-8, 53, 1955 CCH Standard Federal Tax Reporter, Para. 37,118A), Part 1 of the 1942 revision of Bulletin "F" was revoked. But Part 2, including that part which is of primary significance to this case—the tables of useful lives and depreciation rates—was not revoked.

From the foregoing it would seem clear that if the situation were reversed and the taxpayer in this case were contending for any period other than one suggested by Bulletin "F"—be it a two-year period or a six-year period—as the useful life of its automobiles, the defendant would be insisting that in the absence of some justification, such as testimony from the witness stand, or "informed opinion" (Bulletin "F", page 3), or the presentation of experts in the field—Bulletin "F" must govern. Would the Government not be arguing that the unsupported opinion of the taxpayer could not be permitted to *change* the useful life set forth as a guide in Bulletin "F"?

The taxpayer, however, showed affirmatively by witnesses (who were cross-examined by the Government [R. 29-30, 34, 57-58, 64-73] without result except to emphasize facts shown on direct examination) that the applicable useful life, in this case four years (the average of the three-year and five-year guides set forth by the Government in its Bulletin "F"), is the normal useful life for automobiles used in business.

The Government's position is made to look even more peculiar by reason of Treasury Decision 4422, XIII-1 CB 58, issued by the Commissioner of Internal Revenue under date of February 28, 1934 and still in effect. That decision specifically provided that "The burden of proof will rest upon taxpayer to sustain the deduction claimed [for depreciation]." If, as is apparent, Treasury Decision 4422 puts the burden squarely upon the taxpayer to justify its claimed period of useful life, and if, in the absence of proof, Bulletin "F" is to govern, how can the Government justify its opposition to the designation of a four-year useful life for automobiles when (a) the taxpayer justifies its claimed period by clear proof, unopposed by the Government by any other testimony *and* (b) Bulletin "F", designated by the Government as the "guide" of the taxpayer also supports the taxpayer?

With respect to Bulletin "F", the Ninth Circuit has correctly characterized its significance for the case at bar:

> "While we recognize that Bulletin 'F' does not have the force of law, we do believe that a fair construction of the pertinent provisions of such Bulletin, aided by the practice of the Commissioner, reasonably indicates

that *the Commissioner did not consider as a factor in determining depreciation the expected or intended disposal plans of the taxpayer with respect to property used in his trade or business, nor did the Commissioner consider that the useful life of an asset was to be measured by the estimated holding period of such asset by the taxpayer.*" (*Evans* v. *Commissioner of Internal Revenue*, 264 F. 2d 502, 510 (9th Cir. 1959), No. 143, this Term, certiorari granted October 12, 1959; emphasis added.)

Indeed, the Commissioner's new definition of "useful life" is inconsistent with the following rulings, which concerned the availability of capital gain treatment of profit from the sale of rented or leased motor vehicles:

In Rev. Rul. 108, 1953-1 CB 185, the Commissioner referred to the practice of selling automobiles after "leasing them for substantially less than their normal useful life". He certainly was not referring to a useful life which ends when the taxpayer sells the automobiles.

In Rev. Rul. 54-229, 1954-1 CB 124, again the Commissioner referred to a sale of automobiles after they had been leased for substantially less than their useful life. Again he was referring to a useful life in plaintiff's terms—in standard terms and terms consistent with Congressional enactment and intention.[5] *Had the Treasury taken its*

[5] It should be noted that the Commissioner issued Rev. Rul. 54-229, referring to "useful life" in the indicated manner, on June 21, 1954, *after* H.R. 8300, 83d Cong., 2d Sess., was introduced in the House of Representatives on March 9, 1954, with subsection 167(d)—which contained the words "useful life" in two separate places—in exactly the form in which it was finally enacted, and also *after* H.R. 8300 was reported to the Senate by the Senate

present view of "useful life" at the time these revenue rulings were under consideration, there would have been no need for the rulings, since the capital gain issue would have been effectively foreclosed.

It is to be noted that this use by the Commissioner of the term "useful life" occurred—in both instances—in a context in which the question of depreciation on leased cars was expressly considered; and the Commissioner was equating useful life with the total functional life of the automobiles for business purposes despite the practice of the taxpayers involved of disposing of the automobiles well before the end of such functional life.

These rulings, and their interpretation of useful life by the agency charged with the responsibility of administering the Internal Revenue Code, are clearly of persuasive weight under the authorities (*Billings* v. *Truesdell,* 321 U.S. 542, 552-53 [1944]).

The depreciation regulations under Section 167 originally proposed—shortly after enactment of the 1954 Code—by

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(Footnote 5 continued)
Finance Committee on June 18, 1954, with the introductory portion of Section 167(c) identical to the finally enacted language: "Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more . . . ." Moreover, the Senate Finance Committee's Press Release No. 10, made public the Committee's decision on the three-year useful life limitation before June 8, 1954, or approximately two weeks before issuance of Rev. Rul. 54-229, as follows: "The Committee decided not to make the more liberal methods of depreciation on new property available with respect to useful lives of less than three years." (See 100 Cong. Rec. [Part 14] D440, Daily Digest, June 3, 1954.)

the Commissioner (published in the Federal Register on September 28, 1954, at Volume 19, Number 188, pages 6229 to 6234) contained neither a definition of useful life nor any hint that the seasoned, long-continued interpretation of that term would be changed. The regulations originally proposed—published six weeks after enactment of the 1954 Code on August 16, 1954—are far closer to the conception of the "substantially contemporaneous expressions of [administrative] opinion" referred to in *White* v. *Winchester Country Club*, 315 U.S. 32, 41 (1942), than the regulations here in issue, which were proposed more than a year after that enactment and were not finally promulgated until almost two years after passage of the governing statute.

In a number of briefs filed by the Commissioner in depreciation cases both under the 1939 Code and the 1954 Code, the Commissioner has also urged the definition of useful life which plaintiff submits is correct.

A striking case is *Penn* v. *Commissioner of Internal Revenue*, 199 F. 2d 210 (8th Cir. 1952). There, the question was whether depreciation deductions on a building erected by a life tenant at her own expense were to be computed under Section 23(l) of the 1939 Code at a rate based upon the life expectancy of the life tenant, as the taxpayer claimed, or on the useful life of the building, as the Tax Court and the Court of Appeals held. At page 4 of the Commissioner's brief, the Commissioner stated:

> "... Taxpayer points to nothing which supports her novel contention that annual deductions for depreciation of property are to be computed by a life tenant on the basis of his own life expectancy, rather than on the basis of *the useful life of the property itself.*" (Emphasis added.)

And, most significantly, at pages 10-11 of the Commissioner's brief, the Commissioner forthrightly and correctly refutes the very argument which he makes in the present litigation:

"The basic fallacy in taxpayer's argument lies in her assumption that 'depreciation' has reference to the life of the owner of property, rather than to *the life of the property itself.* . . . Taxpayer's argument disregards not only the portion of Section 23(l) which deals specifically with property held by a life tenant, but the *general provision* that depreciation deductions are allowable 'for the exhaustion, wear and tear . . . of property'. *The wear and tear of 'property' has no relation to the life expectancy of its owner. On taxpayer's theory, every owner of a depreciable interest in property would be entitled to deduct annual depreciation at a rate based on the number of years he expects to live and enjoy the income from the property, instead of the number of years the property may be expected to produce income, a result repugnant to the fundamental concepts of depreciation.*" (Emphasis added.)

Both the court's holding and the Commissioner's position in *Penn* are antithetical to the Commissioner's new view of useful life in his 1956 regulations.

Even more recently, in the Commissioner's "Respondent's Brief in Answer," submitted in 1958 to the Tax Court in the *Hillard* case, 31 T.C. 961 (1959), Docket No. 61604, one of his "Points Relied Upon" (page 17) is:

"It is respondent's position that where, as here, petitioner . . . leases [cars] *for substantially less than*

their normal useful life . . . the gain from the sale thereof is taxable as ordinary income." (Emphasis added.)

Further, in the Argument, at page 18, the Commissioner refers to the "leasing [of cars] for substantially less than their normally useful life. . . ."

Another example of the Government's recent admissions of this accepted interpretation of the term "useful life" appears in the Brief for Appellee filed in the Sixth Circuit in *Cohn* v. *United States*, 259 F. 2d 371 (6th Cir. 1958), cited by the defendant in its opening Third Circuit brief (page 33). There, in a refund suit involving depreciation for the years 1942-1944, the Government said (Docket Nos. 13,360-62, brief, page 8): " . . . on the other hand, if the asset will be disposed of long before its useful life has expired. . . ." And later, at page 27, the Government argued that the taxpayers in that case " . . . realized that the goods were to be disposed of, long before the expiration of the assets' useful lives. . . ."

And in the *Cohn* case, the transcript of proceedings (included in the Appendix of Appellants) reveals the following testimony of the technical adviser in the Appellate Division of the Internal Revenue Service assigned to the case:

> Page 245a: "In arriving at the useful life [of furniture, lockers and radio equipment] I considered first that all of this equipment was movable, that *unless it was of such specialized nature that it could not be used in any other business, the useful life of it should be determined by the life of the asset itself;* that a great deal of this equipment, in fact, substan-

tially all of it, *could be used in other businesses;* for instance, the desks that they were using there *could be used anywhere.* I considered the fact that I had worked in offices for a number of years, and I know that the desks, even under the worst treatment, an oak desk would *last* more than ten years." (Emphasis added.)

This certainly is a forthright corroboration of the view that the useful life of an asset for depreciation purposes is its general business life—by whomever used. Further:

Pages 246a-247a: ". . . these partners were engaged in a sort of a war business, and there was some reasonable expectation, or there should have been, that perhaps their business would not last the duration of the war, and that perhaps . . . they could—would dispose of this equipment before the end of its useful life."

It appears impossible to square with that candid statement the 1956 regulations' concept (Reg. Sec. 1.167[a]-1[b]) that useful life is "the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business. . . ."

Indeed, the government is still making the same admission in other cases under the 1954 Code. In *Highland Hills Swimming Club, Inc.* v. *Wiseman, District Director, and United States of America,* 59-1 USTC Para. 9284 (D. C. W. D. Okla. 1958), Docket No. 7672, (*aff'd* 272 F. 2d 176 [10th Cir. 1959]), the Government presented the question (brief, page 2) as follows: "Whether the Commissioner of Internal Revenue correctly determined

that the taxpayer must depreciate its swimming pool over its physical life rather than the term stated in the lease [100 months], under the provisions of Section 167 of the Internal Revenue Code of 1954." And at page 9 of the Government's brief, the following statement appears: "The swimming pool had a useful life of 20 years. It is *not realistic* that the taxpayer only *contemplated its use* for approximately two-fifths of its useful life." (Emphasis added.) Is "useful life" the period of *contemplated use* by a particular taxpayer, as Reg. Sec. 1.167(a)-1(b) says it is? The last sentence of the above quotation appears to constitute a flat denial by the Government that that is the case.

Is the Government shaping basic depreciation principles on an *ad hoc* basis in each case? In *Herbert Shainberg, et al.*, 33 TC No. 28, decided by the Tax Court on November 10, 1959, the taxpayers, who operated a shopping center, had claimed 200% declining balance depreciation, under Section 167(c) of the 1954 Code, just as did the plaintiff in the case at bar. There apparently was agreement that, on any theory of useful life, the assets involved all had useful lives of three or more years. Hence, once past the three-year eligibility question, the Government attempted to stretch out the useful lives of the assets involved in order to produce lower depreciation rates than those claimed by the taxpayers. We believe the Commissioner's brief to the Tax Court in *Shainberg* (Docket Nos. 71618-20), filed on June 18, 1959 and signed by Arch M. Cantrall, Chief Counsel, Internal Revenue Service, speaks for itself:

> "The physical life of the component parts of the buildings is a prime factor to be considered in determining the useful life of these assets. Presumably, unless other factors are present which would reduce the *physical life* of an asset, *there is no reason why the physical life and useful life would not be the same.*" (Page 54; emphasis added.)

Here is a clear admission by the Commissioner that the plaintiff's useful life is correct, for the "other factors" which would reduce an asset's *physical* life certainly do not include the taxpayer's projected holding period.[6]

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[6] The particular *operating practice* of a taxpayer—as contrasted with his projected period of use—certainly may have important effects on the physical life of an asset. Thus the particular use may shorten the ~~total period~~ of economic usefulness materially—usually through abnormally heavy operation or undermaintenance. To the extent that such operating practice is proved (as opposed to merely proving the taxpayer's holding period), a taxpayer is permitted to adjust his depreciation rate accordingly. *Louis E. Whitham, et al.*, 10 TCM 250, 255 (1951). This well-established principle represents a faithful recognition of, and allowance for, the "variables" referred to by this Court in *Detroit Edison Company* v. *Commissioner of Internal Revenue*, 319 U.S. 98, 102 (1943).

Indeed, the Commissioner himself has advocated the principle in unmistakable terms. In *W. N. Foster, et al.*, 2 TCM 595 (1943), the Commissioner—in the face of proof that an automobile was purchased in January, 1938 and sold in January, 1940—argued (Docket Nos. 110779, 110780, Commissioner's reply brief, pages 25-26) as follows: "In Bureau Bulletin 'F' the average useful life of a passenger automobile used in business (other than be [*sic*] salesmen) is 5 years. Petitioners have not proved that the automobile was devoted to such *extraordinary uses* as to justify a higher rate of depreciation than that determined by respondent." (Emphasis added.)

Before the promulgation of his regulations under Section 167 of the 1954 Code, the Commissioner's public pronouncements—Bulletin "F," revenue rulings and briefs submitted to the courts—have without exception defined the term "useful life" in a way consistent with the plaintiff's views as to the meaning of that term. Indeed, the plaintiff has shown that even after the promulgation of his regulations, the Commissioner has taken a position in briefs filed with the courts inconsistent with his contentions in this case.

4. *Expert testimony.*

The consistent judicial interpretation and administrative practice with respect to the meaning of useful life, described above, is fully confirmed by expert opinion, which defendant made no significant effort to rebut at the trial below.

The first two witnesses, accountants with long experience in the field of federal income taxation and partners in firms recognized as leaders in the accounting profession, Ernst & Ernst and Price Waterhouse & Co., testified that during their many years of experience, the term "useful life" meant the business life of an asset, regardless of whether that asset passed from one owner to another (R. 29, 33); and both testified that in their experience the practice has been, in the great majority of cases, to use a four-year life for automobiles used for business purposes (R. 29, 33). Defendant failed to discredit the testimony of these experts on cross-examination, and it is significant that defendant did not offer any testimony of its own in rebuttal.

Taxpayer's last witness, Mr. Donald J. Erickson, a partner in the accounting firm of Arthur Andersen & Co., and in charge of its Chicago office, was called because of his experience and knowledge as an independent public accountant familiar with the tax practices of the automobile rental business. Mr. Erickson, in answer to a direct question, stated that, based on his experience, he would advise a client (described in terms of the basic facts which had been elicited from the witnesses with respect to the practices and operations of plaintiff's business), to use a four-year useful life for the purpose of depreciating the automobiles used in its business. Furthermore, Mr. Erickson stated that his advice to the client would be the same even though it disposed of its automobiles in less than four years, and even though there were changes in style or design or additions of mechanical innovations (R. 60, 64).

On the basis of the testimony of plaintiff's expert witnesses, the District Court below found as a fact that:

> "Over the years, 'useful life' has come to be regarded in the field of business and accounting to mean the business life of an asset regardless of whether it passed from one owner to another."[7] (165 F. Supp. at 265; R. 110.)

(See, in this connection, *The Colony, Inc.* v. *Commissioner of Internal Revenue*, 357 U.S. 28, 32 (1958); *Willcuts* v.

[7]The Third Circuit brushed aside that finding with a mere reference to a textbook treatment (R. 137). Thus the court preferred a statement which could not be the subject of cross-examination at the trial. Moreover, the textbook treatment obviously was relying—at least in part—on the holding of the District Court in the very case at bar.

Milton Dairy Company, 275 U.S. 215, 218 (1927); *Renton Inv. Co. v. Commissioner of Internal Revenue*, 131 F. 2d 330, 335 (3rd Cir. 1942); and *Francisco Sugar Co. v. Commissioner of Internal Revenue*, 47 F. 2d 555, 558 (2d Cir. 1931).)

In the entire course of this litigation, the Government has not offered a single citation of any case or ruling decided or published before the enactment of Section 167 in which it even contended (much less established) that useful life meant a taxpayer's holding period. It is significant that no such citation could be offered. One would think that in the course of decades of administering a statute which required thousands of taxpayers annually to determine for depreciation purposes the useful life of their assets, the Commissioner would have at some point taken the position now being urged by defendant if, as defendant now contends, that had been the position right along. "Against the Treasury's prior long-standing and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand." [8]

B. Useful life for federal income tax depreciation purposes still means the life of the asset for general business purposes, by whomever used, and not a shorter period during which a taxpayer may happen to hold such asset.

We believe the plain fact to be that, until promulgation of the 1956 depreciation regulations, the definition of "useful life" which was "part and parcel of the actual

[8] *United States v. Leslie Salt Co.*, 350 U.S. 383, 396 (1956).

and effective administration of the earlier tax statute"[9] was: the life of the asset during which it still has *usefulness,* and not just the period during which it is held by a given taxpayer until, for reasons perhaps completely unconnected with the newness, oldness or *usefulness* of the asset, it is sold or otherwise disposed of.

What, then, does "useful life" mean in the 1954 Code's depreciation provisions?

We entirely agree with the fundamental premise of the defendant and the Court of Appeals: the depreciation provisions found in the 1954 Code did not change (and were not intended by Congress to change) the meaning of the term "useful life" as it was understood at the time of enactment of the 1954 Code. But, as we have shown, at the time of enactment of the 1954 Code "useful life" meant the physical or inherent functional life of the property.

We shall now review for the Court the legislative history of Section 167 of the 1954 Code, as well as other relevant data, which, we consider, conclusively establish that Congress had no intention, when it enacted Section 167, of changing that long-used and well-understood definition of the term "useful life".

1. *The basic depreciation provision of Section 167 is virtually identical to the pre-existing basic provision.*

The following table traces briefly the basic depreciation provision of the 1939 Code and prior revenue acts, and shows the stability of this provision over a period of 41 years—from 1913 to 1954:

[9] *Jackson Finance and Thrift Co.* v. *Commissioner of Internal Revenue,* 260 F. 2d 578, 581 (10th Cir. 1958).

Depreciation Provision	Statute
"A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business".	Subdivision B, sixth, Revenue Act of 1913 (38 Stat. 114 [1913])
"A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade".	Section 5(a) seventh, Revenue Act of 1916 (39 Stat. 756 [1916]); and Section 5(a) seventh, Revenue Act of 1917 (39 Stat. 756 [1916]), as amended by Act of October 3, 1917 (40 Stat. 300 [1917]).
"A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence"	Section 214(a)(8), Revenue Acts of: —1918 (40 Stat. 1057 [1919]), —1921 (42 Stat. 227 [1921]), —1924 (43 Stat. 253 [1924]). Sections 214(a)(8) and 234(a)(7) of Revenue Act of 1926 (44 Stat. 9 [1926]). Section 23(l), Revenue Acts of: —1928 (45 Stat. 791 [1928]), —1932 (47 Stat. 169 [1932]). Section 23(l), Revenue Acts of: —1934 (48 Stat. 680 [1934]), —1936 (49 Stat. 1648 [1936]), —1938 (52 Stat. 447 [1938]). Internal Revenue Code of 1939 (53 Stat. 1 [1939]).
"A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)— (1) of property used in the trade or business, or (2) of property held for the production of income."	Section 23(l), Internal Revenue Code of 1939, as amended by the Revenue Act of 1942 (56 Stat. 798 [1942]), and as in force up to the effective date of Section 167 of the 1954 Internal Revenue Code.

(See 1954 Code provision at page 52, *infra.*)

Running parallel with this constant statutory provision were basic regulations on depreciation which also remained virtually unchanged, in all respects material to the present case, from 1918 to the date on which the Commissioner issued his new 1956 regulations. Those regulations are important because they mention "useful life". A succinct description of all of the relevant depreciation regulations which had been in force before Congress addressed itself to the 1954 Code appears in *Evans* v. *Commissioner of Internal Revenue*, 264 F. 2d 502, 507, 508 (9th Cir., 1959), No. 143, this Term, certiorari granted October 12, 1959:

> "The first appearance of the [term] 'useful life' . . . in Treasury Regulations was in Treasury Regulations 45, Article 161 (1919), effective for the calendar years 1918-19 and 1920. Article 161 provided in part, as follows: 'The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the *useful life of the property in the business* will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost * * *' (Italics added.)
>
> "Article 165 of the same Regulations provided in part, as follows: 'The capital sum to be replaced *should be charged off over the useful life of the property* * * *'. (Italics added.)
>
> "Similar wording with changes not material to the problem before us appeared in subsequent Treasury Regulations through Regulations 103, Section 12.23 (l)-1-5, effective for the tax years 1939-40 and 1941.

The words 'in the business' which appeared in Article 161 of Regulations 45 continued to appear in successive regulations until the issuance of Regulations 111 in 1942. No definition or further explanations of the [term] 'useful life' . . . appeared in any of the regulations to which reference has been made until the issuance of Treasury Regulations T.D. 6182, promulgated under the 1954 Revenue Code. The [term] 'useful life' . . . [is] not defined or explained in Regulations 111. The language of the Regulations does not limit 'useful life' to the useful life of the depreciable assets in the business of the taxpayer or to the period during which such assets are held by the taxpayer."

Thus, the law on useful life, as it stood when Congress proceeded to consider the drafting and adoption of the 1954 Code, consisted of the following:

(i) A basic depreciation statute re-enacted many times, substantially unchanged, in successive revenue acts over a period of more than 40 years, in the light of, and without any significant change in

(ii) the Commissioner's basic depreciation regulations, which had been long continued in virtually identical form since 1918, and which

(iii) were consistently interpreted by the courts, and by the Commissioner himself, as applying and defining useful life as the life of an asset for general business purposes and not the period during which it happens to be held by a particular taxpayer.

That interpretation of useful life had the force of law by virtue of repeated re-enactment by Congress of the underlying legislation, under the principle of *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938):

"Treasury regulations and interpretations long continued without substantial change, applying to un-

amended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."

Accord: *Commissioner of Internal Revenue* v. *Flowers*, 326 U.S. 465, 469 (1946); *Boehm* v. *Commissioner of Internal Revenue*, 326 U.S. 287, 291-92 (1945); *Lykes* v. *United States*, 343 U.S. 118, 127 (1946); *Cammarano* v. *United States*, 358 U.S. 498, 510-11 (1959).[10]

Now let us observe what Congress did with the basic depreciation provision in enacting Section 167 of the 1954 Code. The substantive language of the provision is, indeed, identical to that of its immediate predecessor in the 1939 Code:

1939 Internal Revenue Code Section 23(l)	1954 Internal Revenue Code Section 167(a)
"In computing net income there shall be allowed as deductions: "(l) DEPRECIATION.—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)— "(1) of property used in the trade or business, or "(2) of property held for the production of income."	"(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)— "(1) of property used in the trade or business, or "(2) of property held for the production of income."

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[10] In *Cammarano*, (Nos. 29 and 50, October Term, 1958), the Government argued (Brief for Respondent, page 11):

> "The regulation in question, having been in existence for some forty years and during a period in which the underlying statutory provision has been repeatedly reenacted, has acquired the force of law."

As this Court has recently pointed out in *Cammarano*, 358 U.S. 498 (1959) (involving the Treasury Department's regulatory language of more than 40 years' continuous duration):

> "It is also noteworthy that Congress, in its 1954 re-enactment of the Internal Revenue Code, again adopted the 'ordinary and necessary' provision without substantive change, *following consistent rulings by the courts subsequent to the 1939 re-enactment holding these Regulations applicable to* [deductibility of the sums in issue]. . . . Although the tax years involved in the cases before us are 1948 and 1950, and a 1954 re-enactment of course cannot conclusively demonstrate the propriety of an administrative and judicial interpretation and application as made to transactions occurring before the re-enactment, *the 1954 action of Congress is significant as indicating satisfaction with the interpretation consistently given the statute by the regulations here at issue and in demonstrating its prior intent.*" (358 U.S. at 510; emphasis added.)

But Congress went further in the 1954 depreciation enactment. It took from the Treasury Department's depreciation regulations and placed in Section 167 a term—"useful life"—which had been in those regulations since 1918 and which repeated court decisions, administrative rulings and practice had given a long-standing federal tax meaning: life for general business purposes, without reference to a particular taxpayer's holding period.

Moreover, the depreciation statute, at Subsection 167(b), shows, within itself, Congress's intention to retain that long-standing definition. The wording of Paragraph (4)

of that Subsection distinguishes between the period of a taxpayer's use and "useful life". That portion of the statute permits a taxpayer to use (as alternatives to the straight-line method, the double declining balance method or the sum of the years-digits method) "any other consistent method productive of an annual allowance [for depreciation] which, when added to all allowances for the period commencing with *the taxpayer's use* of the property and including the taxable year, does not, during the first two-thirds of *the useful life* of the property, exceed . . . [the total depreciation permitted under the declining balance method]" (emphasis added). This distinction—*in the statute itself*—between the period of "*the taxpayer's use*" of the property and "*the useful life*" of the property can hardly be considered accidental.[11] Both terms actually appear within the same sentence. It was indeed less natural to import the term "useful life" into that sentence than it would have been to use, instead, the term "period of the taxpayer's use."

2. *Congress was acting in the context of the long-settled meaning of the phrase "useful life", having apparently seen no necessity to enact (or even discuss the need for) a definition of it.*

The term "useful life," we wish to emphasize, had never appeared in the portions of the federal income tax stat-

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[11] "It is the duty of the court to give effect, if possible, to every clause and word of a statute, avoiding, if it may, any construction which implies that the Legislature was ignorant of the meaning of the language it employed." *Inhabitants of the Township of Montclair* v. *Ramsdell*, 107 U.S. 147, 152 (1883); *United States* v. *Menasche*, 348 U.S. 528, 538-39 (1955).

utes dealing with depreciation prior to 1954. However, the phrase does appear, *without definition,* in Subsections (b), (c) and (d) of Section 167, and is frequently referred to, *again without definition,* in the committee reports on H.R. 8300, 83d Cong., 2d Sess., which ultimately was enacted as the 1954 Code (*e.g.*, at page 201 *et seq.* of Senate Report No. 1622, 83rd Cong., 2nd Sess. [3 U.S.C. Cong. & Adm. News (1954) 4836 *et seq.*]—hereinafter referred to as the "Senate Report").

As pointed out in *Commissioner of Internal Revenue v. Neustadt's Trust,* 131 F. 2d 528, 530 (2d Cir. 1942):

> "A court is justified in believing that when Congress employs in a tax law words having a well defined meaning in the business world, it used them with that meaning in the absence of clear evidence to the contrary."

In the 1954 Code, Congress was using the phrase "useful life" in the depreciation statute for the first time. If some meaning other than its traditionally accepted meaning had been intended, Congress would certainly have added a qualification of its own, such as "limited by the use of the assets by the taxpayer" or "until sold or otherwise disposed of by the taxpayer"—or some other such explanatory words.

The Government's attempt to attach such meanings to the unembellished statutory words "useful life" contravenes the rule that the language employed in the statute is at least the primary guide to legislative intention. *United States* v. *American Trucking Associations, Inc.,* 310 U.S. 534, 543 (1940). In *Webster's New International Dictionary of the English Language,* Second Edition, Un-

abridged (Merriam-Webster, G. & C. Merriam Company, Springfield, Massachusetts, 1951), definition 9c of "life" is, in part:

> ". . . the period of time during which a material object is fit for use or during which it efficiently performs its functions or the number of times it may be used; as, the *life* in years of an iron girder; the *life* of a gun barrel in rounds."

The same source defines "useful," in part, as:—

> "Full of use; producing, or having power to produce, good; serviceable for any end or object; helpful; capable of any beneficial use, as distinguished from that which is vicious or pernicious; having utility (which see); beneficial; advantageous. . . ."

3. *The contexts in which the words "useful life" were used in the legislative history of Section 167 show that Congress intended them to have the established meaning of physical or inherent functional life.*

(a) The committee reports.

At page 201 of the Senate Report (3 U.S.C. Cong. & Adm. News [1954] 4836), the Senate Finance Committee pointed out, in discussing the declining balance method:

> "The salvage value is not deducted from the basis prior to applying the rate, since under this method at the expiration of *useful life* there remains an undepreciated balance which represents salvage value." (Emphasis added.)

And at page 26 of the Senate Report (3 U.S.C. Cong. & Adm. News [1954] 4657) the Committee pointed

out that a characteristic feature of the declining balance method was that it left an unrecovered portion of some 10 to 13 percent of cost at the end of service life;[12] and at page 28 (3 U.S.C. Cong. & Adm. News [1954] 4658) the Committee also refers to the "automatic 10 to 13 percent salvage value characteristic of the declining-balance system". If a period-of-use-by-the-taxpayer concept of useful life had been intended, the statement at page 201 (3 U.S.C. Cong. & Adm. News [1954] 4836) could not be true, since salvage value, under the Commissioner's new definition, would then be the estimated sales proceeds at the end of an asset's use to a particular taxpayer, which might be exceedingly high (instead of the small, automatic residuum referred to at pages 26-28 [3 U.S.C. Cong. & Adm. News (1954) 4656-4658] of the Senate Report), and of course would not be "automatic" but would fluctuate widely, depending upon the time of sale, condition of the asset, state of the market and other imponderables.

Similarly, the Committee stated (Senate Report, page 29, 3 U.S.C. Cong. & Adm. News [1954] 4659):

> "The use of the 200 percent declining-balance rate in the case of *short-lived properties* would result in extremely fast writeoffs." (Emphasis added.)

The emphasized words, we submit, were inapposite if the intention were to refer to properties *held* for a short time.

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[12] An examination of the use of the term "service life" at pages 26 and 27 (3 U.S.C. Cong. & Adm. News [1954] 4657, 4658), and particularly in paragraph (c) on page 29 (3 U.S.C. Cong. & Adm. News [1954] 4659), of the Senate Report shows that the Committee was using that term interchangeably with "useful life".

Moreover, neither the Senate Report nor the report of the House Ways and Means Committee (House Report No. 1337, 83rd Cong., 2nd Sess.—hereinafter referred to as the "House Report") refers to taxpayers' holding periods; instead, there are repeated references to:

Senate Report: "a property's life" (p. 27) (3 U.S.C. Cong. & Adm. News [1954] 4658),

"the life of a property" (p. 27) (3 U.S.C. Cong. & Adm. News [1954] 4658),

"the estimated life of the property" (p. 201) (3 U.S.C. Cong. & Adm. News [1954] 4836), and

"the estimated useful life of the property" (p. 201) (3 U.S.C. Cong. & Adm. News [1954] 4837).

House Report: "the life of a property" (p. 23) (3 U.S.C. Cong. & Adm. News [1954] 4047), and

"the life of the property" (p. A48) (3 U.S.C. Cong. & Adm. News [1954] 4185).

What was *not* said by the respective Committees is quite as significant as what *was* said in their reports. The Committees need only have defined the term "useful life" to mean "the period of use by the taxpayer," or used words of similar import if it were their intention to effect a change in the concept.

(b) Committee hearings and Congressional debates.

Similarly, as in the committee reports, the committee hearings and the debates on the House and Senate floors fail to disclose a single instance where the intention to change the definition of "useful life" is manifested.

There are, on the other hand, discussions and expressions of the useful life concept which underline the common understanding that "useful life" was being used as general life for business purposes.

Thus, at the Senate Finance Committee hearings, Senator Bennett (a member of the Committee) stated (Part 1, page 137, Hearings before the Committee on Finance, United States Senate, 83rd Cong., 2nd Sess., on H.R. 8300—hereinafter called the "Senate Hearings"):

> "When this man sells this particular machinery before he has exhausted its *actual life* in order to buy something else, he pays a profit [*sic*] on the difference between the price at which he sold it and the amount to which he depreciated it. If he depreciates it *all the way*, he pays tax on the sale price." (Emphasis added.)

But that result—that is, that the taxpayer pays tax "on the sale price"—can be true only if the asset's depreciated basis at the time of sale is substantially zero. And the depreciated basis cannot be such under the Commissioner's new definitions of useful life and salvage value, because those definitions, in essence, limit the depreciation allowable to the difference between cost and sales proceeds. Indeed, Senator Bennett's statement has another significance: the reference "If he depreciates *it all the*

way . . . ." is far more consistent with the plaintiff's concept of useful life as a relatively objective period of depreciability of the property itself than with the Government's concept of periods of specific use by particular taxpayers.

Further, at page 118 of the same hearings, Undersecretary of the Treasury Marion B. Folsom, in discussing the accelerated depreciation provisions of H.R. 8300, pointed out that:

> "The big advantage of this proposal is that in the first place your asset is written off in the way in which depreciation actually occurs. A machine, like an automobile, depreciates much faster in the first few years than later on. We are simply recommending going in accordance with actual practice. The big advantage of it is that it would stimulate people to scrap old machines and buy new machines because you can get your money back in tax reductions quicker than you can under the other method."

The "way in which depreciation actually occurs" clearly refers to "exhaustion, wear and tear" under Section 23(l) of the 1939 Code and Section 167(a) of the 1954 Code. Certainly it does not refer to reduction in market value, since the last regulations under the 1939 Code described depreciation as "excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence" (Reg. 118, Sec. 39.23[l]-1), and the present regulations repeat the formula that the depreciation allowance "shall not reflect amounts representing a mere reduction in market value" (Reg. Sec. 1.167[a]-1[a]).

Furthermore, on July 2, 1954, after the provisions of Section 167 had been reported to the Senate by the Senate Finance Committee, a floor discussion among Senators Douglas, Daniel, Millikin and Frear (Senator Millikin being Chairman, and Senator Frear a member, of the Senate Finance Committee) points up the fact that the debate proceeded in terms of the physical life of depreciable assets and not in terms of a taxpayer's holding period. (This discussion, to which we direct the Court's special attention, is reprinted in Appendix B to this brief, pages 115 to 119, *infra.*)

Indeed, the very theory and language of the holding period concept was before Congress during the same session at which the 1954 Code was drafted, considered and enacted. On January 14, 1954 there was introduced and referred to the House Ways and Means Committee H.R. 7173. This bill proposed that taxpayers be permitted to determine their own depreciation rates on new property, subject to the limitation that not more than 50% of the basis of property could be deducted in the year of acquisition—but at the price of treating gain resulting from the accelerated reduction of basis as ordinary income and not capital gain.[13] Section 2 of the bill provided:

[13] This method of dealing with rapid depreciation is exactly the method which Congress had enacted with respect to the amortization of emergency facilities in Sections 124A and 117(g)(3) of the 1939 Code, and which it was to reaffirm in Sections 168 and 1238 of the 1954 Code. Significantly, with H.R. 7173 before it, Congress did not see fit to enact a like limitation in connection with the sale of depreciable property generally.

"Sec. 2. Section 117 (g) (3) of the Internal Revenue Code is amended to read as follows:

> "(3) Gain from the sale or exchange of property, to the extent that the adjusted basis of such property is less than the adjusted basis determined without regard to section 23 (l) (2) (relating to new machinery and equipment) and 124A (relating to amortization deduction), shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in subsection (j). This paragraph shall not apply to gain attributable to deductions allowed under section 23 (l) (2) in the case of equipment *held* for more than five years." (Emphasis added.)

In discussing the bill, Representative Bow stated, at 100 Cong. Rec. (Part 1) 268, 83rd Cong., 2d Sess.:

> "In order to prevent the possibility that taxpayers might write off new equipment against income over a short period of time, and then sell it for tax advantage, the bill provides that in the event of a sale of such machinery or equipment *held* for less than 5 years, the difference between its adjusted basis computed under the new election and the adjusted basis otherwise determined shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in subsection (j)." (Emphasis added.)

If Congress wished to inject a holding period concept into the depreciation provisions of the 1954 Code, not only did it have apt language in H.R. 7173, but

that language was contained in a bill directed to the very situation which defendant now seeks to act upon without the benefit of Congressional authority. But the House Ways and Means Committee did not recommend, and Congress did not adopt, the theory or language of H.R. 7173. Instead, it used the established words "useful life" in the sole limiting condition which it imposed on the accelerated depreciation of new business property.

4. *The legislative history of Section 167 further shows Congress's clear intention to stimulate capital investment by liberalizing the methods of computing depreciation.*

The legislative history of Section 167 clearly reveals the policy considerations underlying the enactment of the accelerated depreciation provisions. The country experienced a mild recession in 1953 and 1954 which the administration and Congress believed was attributable, in substantial measure, to the relative inactivity of the capital goods industries.[14] The record shows that by allowing special tax write-offs of depreciable property, the administration and Congress intended to create, and believed they were creating, strong and continuing incentives for the purchase of new business assets. Thus, the House Ways and Means Committee stated, at page 24 (3 U.S.C. Cong. & Adm. News [1954] 4048) of the House Report:

> "The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision

[14] See, for example, the statement of Secretary of the Treasury Humphrey at pages 97-99 of the Senate Hearings.

of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion."

To the same effect is the Senate Report, at pages 25 and 26 (3 U.S.C. Cong. & Adm. News [1954] 4656):

"The liberalized declining-balance method included in the bill concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness.[15] With the rate limited to twice the corresponding straight-line rate and based on a realistic estimate of useful life, the proposed system conforms to sound accounting principles.

"More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment."

The tax effects and temporary revenue loss of accelerated depreciation were entirely foreseen and deliberately enacted as part of the general economic and taxation policy of the federal government to induce a greater turnover of depreciable assets, increased employment and a more prosperous economy in subsequent years.[16]

[15] Not, it should be noted, the pattern of loss of usefulness to a particular taxpayer.

[16] In a summary of the principal provisions of H.R. 8300 prepared for the use of the Senate Finance Committee by the technical staff of the Joint Committee on Internal Revenue Taxation, the revenue effects of the new declining balance method were summarized as follows (Senate Hearings, page 20):

How was this policy to be implemented so far as depreciation was concerned?

Since Bulletin "F" useful lives were regarded by some taxpayers as on the conservative (*i.e.*, long) side, considerable pressure developed to allow faster write-offs.[17]

(Footnote 16 continued)

> "Ignoring any stimulus to investment and assuming all eligible taxpayers adopt the declining balance, the loss in the fiscal year 1955 would be about $375 million. In the second and immediately subsequent years *there would be greater losses*, again ignoring any effect on investment." (Emphasis added.)

The Senate Finance Committee stated:

> "It is estimated that the declining balance depreciation of this bill as amended by your committee will result in a revenue loss of $400 million in the fiscal year 1955." (Senate Report, page 29, 3 U.S.C. Cong. & Adm. News [1954] 4659.)

Indeed, Congress was aware of expert opinion that the revenue losses might be greater. It received a warning (Senate Hearings, page 677) that the Joint Committee on Internal Revenue Taxation estimated the revenue loss in subsequent years (beyond the estimated $375,000,000 loss in the first year) as $1,040,000,000 in the second year, and $1,550,000,000 in the third year.

Congress knew that the maximum potential total of depreciation over the full useful life of depreciable assets could not, under any method of depreciation, go beyond cost; and that if and when such assets were sold considerably before the end of their useful life, as Congress hoped they would be, the taxpayer would pay a capital gains tax on the profit. As Senator Bennett said to the Senate Finance Committee (Senate Hearings, page 137):

> "I would like to get into the record the assumption that depreciation can only be taken once and every man has the right to fully depreciate the assets which he buys. . . . If he depreciates it all the way, he pays tax on the sale price." (Emphasis added.)

[17] See, among the many examples in the hearings held on the 1954 Internal Revenue Code, the statement of the Chamber of Commerce of the United States at page 1945 of the Senate Hearings.

Congress had basically two alternatives if, as it said, it wished to liberalize depreciation: (1) It could change the concept of "useful life" by legislating specific lives for assets or by giving taxpayers some latitude in choosing their own useful lives for assets. This Congress did not choose to do.[18] (2) Alternatively, Congress could,

[18] Significantly, actual attempts to introduce such legislation have come to nothing. In 1947 and 1948, companion bills—H.R. 4789, 80th Congress, 1st Session, and H.R. 5142, 80th Congress, 2nd Session—were introduced to permit taxpayers to elect a useful life of twenty years (or more) for assets with a useful life in excess of twenty years. No action was taken on these bills. In 1953, H.R. 5702 and S. 298—substantially identical bills in the 83rd Congress, 1st Session—were introduced "to afford the taxpayer the right to determine the period of useful life of property in computing deductions for depreciation under the income tax laws." The Treasury rendered an adverse report on S. 298, and both bills died without action. See also the depreciation proposal of Representative Thom (debated at 79 Cong. Rec. 12425-26, August 3, 1935, 74th Congress, 1st Session), which would have allowed the write-off of equipment in the year of acquisition, as a means of stimulating the capital goods industry. In 1958, S. 3718 (85th Congress, 2nd Session), which also died without action, would have made the useful life of any depreciable property, at the election of the taxpayer, a specific period, depending on the longevity of the property. In introducing this bill, Senator Capehart, its sponsor, stated (104 Cong. Rec. 7487, April 28, 1958):

> "Mr. President, as I have said, each Senator has been provided with a copy of schedule [*sic*] F, entitled 'Tables of Useful Lives of Depreciable Property, issued by the United States Treasury Department, IRS 173. This schedule contains tables of the numbers of years of useful life of capital investments *as now computed by the Bureau of Internal Revenue*." (Emphasis added.)

and did, retain the existing inherent business life concept of useful life, permitting taxpayers to apply to it the new techniques of depreciation of which the 200% declining balance method is an example.

The result has been well stated in Barlow, "Depreciation," *Tax Revision Compendium, Committee on Ways and Means, November 16, 1959*, Vol. 2, page 832:

> "... Congress provided in the Internal Revenue Code of 1954 for two new methods of depreciation.
>
> "These methods are of course well known as double-declining balance and the sum-of-the-years digits. They permit a taxpayer to write off the cost of an asset more rapidly during the first years of its life than was previously permitted under the traditional straight-line method. *But they have no effect on the length of the period—the life—over which the total writeoff must be made. In other words, they retain the Bulletin F concept and listed lives* . . . ." (Emphasis added.)

Indeed, the continuing legislative consideration of and debate on depreciation policy clearly reflects the inconsistency of the defendant's position herein. In "Tax Depreciation Allowances on Capital Equipment," a report of the Senate's Select Committee on Small Business,[19] the Committee states (page 8):

> "Adjustments in depreciation policy can be made by one or more of three approaches: (1) by permitting a greater proportion of depreciation allowances in the

[19] Senate Report No. 1017, 86th Congress, 2nd Session (January 7, 1960).

years immediately after acquisition of the assets to be depreciated, (2) by increasing the amount of depreciation to be allowed, and (3) by reducing the time for depreciating assets.

"The Congress used the first method in 1954 and 1958. In 1954 it authorized the use of two accounting formulas [sum of the years-digits and double declining balance methods] which permitted proportionately greater depreciation allowances on an item in the years immediately following its acquisition than in subsequent years. By the adoption of section 204 of the Small Business Tax Revision Act of 1958, Congress permitted a 20-percent first-year depreciation allowance in addition to normal depreciation rates. This additional first-year allowance is limited, however, to 20 percent of $10,000 in assets of each taxpayer. *However, there has been no change in the total amount of depreciation permitted. That has been limited to the actual, historical cost of an item*—with some vacillation on Treasury's part concerning treatment of salvage value." (Emphasis added.)

An authoritative source[20] puts it this way:

"From 1934 to 1954, the Treasury and congressional attitudes on depreciation allowances were under constant attack by industry. Depreciation problems constituted a major source of conflict and occasioned many controversies between taxpayers and the Bureau of Internal Revenue. The basic problem generally at issue was the alleged too long estimated useful life placed on assets by the Bureau and the relatively slow

[20] *The Federal Revenue System: Facts and Problems 1959, Materials Assembled by the Committee Staff for the Joint Economic Committee, Congress of the United States,* Joint Committee Print, 86th Congress, 1st Session, page 70.

writeoff permitted over this useful life, with the result, charged by taxpayers, that they lacked an opportunity to recover their investments with sufficient promptness. The policy was frequently referred to as presenting a deterrent to investment.

"The only important legislative departures from this strict policy were the adoption in 1940 and 1950 of provisions for accelerated amortization of defense facilities during World War II and the Korean war and thereafter.

"The adoption of the Internal Revenue Code of 1954 specifically authorized the use of the more liberal 200 percent declining balance and sum of the years-digits methods of depreciation. It did not, however, involve any changes with respect to the useful lives over which assets might be written off, nor any change in the historic cost basis for depreciation allowances."

C. The history of Section 1231 of the 1954 Code (Section 117[j] of the 1939 Code).

The useful life-salvage value controversy in the present case cannot be understood without reference to the question of capital gains treatment of profits on the sale of depreciable business property. It is one of the measures of the inadequacy of the Court of Appeals' opinion below that the opinion does not consider—or even mention—the subject of such capital gains treatment.

For although this case is in form a technical dispute about depreciation, it is, in substance, another of the Treasury Department's continuing—and thus far unsuccessful—attempts to limit, without Congressional sanction, the application of Section 1231 of the 1954 Code (formerly Section 117(j) of the 1939 Code), which permits capital

gain treatment of profit on the sale of depreciable property held for more than six months. Indeed, as much has been admitted by the Government. At page 40 of the Government's opening Third Circuit brief appears this frank statement:

> "The simple fact is that the profit is taxable at capital gains rates and taxpayer, under its view, receives the benefit of a deduction at a 52% rate and pays tax on the profit resulting from the increased deduction at a 25% rate. *This result can be avoided* by defining useful life for purposes of depreciation as meaning the period during which an asset is useful to the taxpayer (together with a reasonable computation of salvage value). *This has been done* in Section 1.167(a)-1(b) of the Regulations." (Emphasis added.)

This down to earth language brings the real issue into the open; it is a candid admission that the Treasury is attempting to repeal—or at least severely limit the application of—Section 1231, by the issuance of specially tailored regulations under Section 167.

The same admission has recently been made at a very high level in the Treasury. In the February, 1959 number of the *Journal of Taxation*, Mr. Darrell S. Parker, Chief of the Engineering and Valuation Branch of the Internal Revenue Service, writes:[21]

> "It is evident that Section 1231 is the principal cause of the examining agent's investigation of the salvage question. It is common knowledge that consideration was given in 1958 by Congress to a proposal

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[21] 10 *Journal of Taxation*, 69, 70.

that the lives of various groups of depreciable assets be reduced and, if the taxpayer elected to use the group life for which it qualified, the treatment under Section 1231 would be waived upon all disposal of depreciable property included within such group."[22]

These considerations are, of course, in the highest degree proper subjects for *legislative* action.

But defendant in this case is attempting to assert a new *administrative* definition of "useful life" (Reg. Sec. 1.167 [a]-1[b]) which, when combined with his misapplication of a superimposed salvage value to the double declining

[22] Indeed, the problem for which the defendant has sought an unauthorized administrative solution in this case was clearly foreshadowed by the present Chairman of the House Ways and Means Committee, Wilbur D. Mills (then Chairman of that Committee's Subcommittee on Internal Revenue Taxation), in a speech made before the American Bar Association's Section of Taxation on August 25, 1956—shortly after promulgation of the regulations here in issue:

> "The fact that the new [1954] Code has substantially altered the 1939 Code in [certain] areas has, of course, left unresolved pressing substantive issues. Indeed, many of these issues have been brought into sharper focus by virtue of changes elsewhere in the Code. For example, *the accelerated depreciation methods incorporated in section 167 have changed the perspective in which the revenue consequences, the economic impact and equity considerations of section 1231--old section 117(j)—must be viewed.* A major order of business for the Subcommittee on Internal Revenue Taxation, therefore will be to cover ground not adequately ~~or~~ successfully explored in the 1954 revision." (Emphasis added.)

(Section of Taxation *Bulletin*, October 1956, American Bar Association, pages 9-10.)

balance method (Reg. Sec. 1.167[b]-2[a]), discussed below, will result in a disallowance to taxpayers of capital gains upon the sale of business assets under Section 1231 of the 1954 Code. In short, the Commissioner's current change in position is clearly motivated by something which lies beyond the use of the double declining balance method: if now he can succeed in preventing the application of the double declining balance method, he can succeed in preventing the realization of a capital gain which results to the taxpayer in many cases out of the application of that method of depreciation.

The Treasury has tried several times to prevent the realization of capital gains on the sale of depreciable business property under Sections 117(j) and 1231 in other ways—without success. In the light of the history of those provisions, it is astonishing to see the Commissioner continuing his efforts arbitrarily to vitiate them.

During the extensive Revenue Revision hearings held by Congress in 1947 and 1948, the Business Tax Section of the Division of Tax Research of the Treasury Department submitted a report on accelerated depreciation to the Ways and Means Committee of the House of Representatives ("Revenue Revisions, 1947-1948", hearings of December 2-12, 1947, Part 5, page 3756), in which the Treasury Department attempted to reduce the effect of the capital gains section in the 1939 Code (Section 117 [j]), stating:

> "[A] danger is that accelerated depreciation allowances might be used to convert ordinary income into capital gains, since a businessman might sell a fully

depreciated asset that still had a substantial value, paying a tax on the capital gain and avoiding the taxes on its income that were deferred during the period of accelerated depreciation. This type of avoidance could be overcome by requiring that if the taxpayer elects to use accelerated depreciation, gain to the extent of the excess of accelerated over normal depreciation must be treated as ordinary income."

This initial straightforward attempt by the Treasury Department to change the design of the statute authorizing capitals gains treatment for profits realized from the sale of assets subject to accelerated depreciation failed because Congress was adhering to the above-described policy of encouraging the sale of capital equipment and thus encouraging the purchase of new capital equipment.

Shortly thereafter, the Treasury Department took a different approach in its attack on Section 117(j). It recommended to Congress in 1950 that losses on the sale of depreciable business property be treated as capital rather than ordinary losses. On February 3, 1950, Secretary of the Treasury Snyder told the House Ways and Means Committee:[23]

"Another important loophole provides a 'one-way street' for taxpayers selling property which they have used in their trade or business. At the present time, such taxpayers are allowed capital-gains treatment when the sales result in a net gain, while net losses from such transactions are allowed in full as offsets against ordinary income."

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[23] Hearings before the Committee on Ways and Means, House of Representatives, 81st Cong., 2nd Sess., "Revenue Revisions of 1950," Volume 1, page 20.

Secretary Snyder referred at the same page to Exhibit 4 to his statement—a list of "Miscellaneous Tax Loopholes" prepared by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation. This exhibit stated, in part:[24]

> "The justification which the section [117(j) of the 1939 Code] might have had at the time of its enactment is believed to have disappeared with the termination of the war."

But Congress refused in 1950—as it refused in 1954 and still refuses—to eliminate the so-called one-way street in the taxation of gains on the sale of business property.

The third attempt by the Internal Revenue Service to limit capital gains treatment for gains from the sale of depreciable property took the form of a contention, under Section 117(j) of the 1939 Code, or Section 1231 of the 1954 Code, that the assets in question were held "primarily for sale to customers in the ordinary course of [taxpayer's] trade or business" and that profits on such assets' sale thus were ineligible for capital gains treatment.

That attempt also failed. That approach was closed off in the *Philber* case, 237 F. 2d 129 (3rd Cir. 1956).

Defendant's current contention represents a fourth approach, a back door through which the Internal Revenue Service hopes to be able to strike down or substantially impair capital gains treatment of such profits. The latest attempt is to claim that the useful life of business automo-

[24] *Ibid.*, Volume 1, page 71.

biles is not the usual and accepted period of four years, but is a year and a half or two years (anything less than three years). Thus the right to use declining balance depreciation would be cut off by Section 167(c) of the 1954 Code. The taxpayer is thereby relegated to straight-line depreciation. If salvage value is then defined as meaning whatever amount the taxpayer can get for an automobile at the end of a year and a half or two years, there is relatively little asset value left to depreciate, and there can be little or no capital gain.

When Congress was considering the 1954 Code, the question of capital gains on the sale of business property was specifically brought to its attention by the Committee on Federal Taxation of the American Institute of Accountants. On April 19, 1954, that group filed with the Senate Finance Committee its Recommendation No. 180 with respect to Section 1231 (Senate Hearings, Part 3, page 1324), as follows:

> "Gain or loss on property used in the trade or business, etc., should be treated uniformly as ordinary income or loss."

But Congress rejected this recommendation because it wished to encourage businessmen to sell capital assets earlier than they might otherwise sell them and, by paying the lesser capital gains tax rates on the profit that might be realized, be in a better position to buy new capital assets to take their place.

Congress made it clear that Section 117(j), its earlier provision in the 1939 Code for capital gains treatment of

profits on the sale of business property, was not being disturbed. Page A275 (3 U.S.C. Cong. & Adm. News [1954] 4417) of the House Report states, with respect to Section 1231:

> 'This section is derived from section 117(j) of the present law. There is no substantive change intended but some rearrangement has been made."

Particularly at the time of the consideration and adoption by Congress of the 1954 Code, automobile production—a key economic barometer—had fallen substantially.[25] In the absence of special incentive, the natural tendency of corporations at such a time was to hold depreciable assets and wait for a more advantageous time for selling partially depreciated assets and for buying new ones. Congress intentionally offered a special incentive for selling earlier rather than later, and for replacing with new purchases now rather than at some time in the future. And Congress did this in the face of explicit opinion that the combination of the new depreciation methods and the capital gains provisions of Section 1231 might well "accentuate" the advantage of the favorable capital gains tax rate over the standard income tax rate.[26]

[25] Average monthly factory sales of passenger cars in the United States declined from 509,746 in 1953 to 463,241 in 1954. Page 196, *Business Statistics*—1959 *Biennial Edition,* U. S. Department of Commerce, Office of Business Statistics (1959). Average monthly factory sales of trucks similarly declined—from 100,184 in 1953 to 86,505 in 1954. *Ibid.*

[26] See remarks of Representative Curtis, of Missouri (a member of the House Ways and Means Committee), on H.R. 8300 at 100 Cong. Rec. 3678 (March 22, 1954).

It is highly significant that Congress limited capital gains on sales of emergency facilities in Sections 168 and 1238 of the 1954 Code; and yet left untouched the neighboring Sections 167 and 1231, sections controlling this case and applicable to ordinary depreciable property.[27]

The Treasury Department is still nevertheless trying to do, by regulation, what Congress refused to do when that very question was specifically put before it.

Indeed, as this brief was being written, the President's budget message to Congress of January 18, 1960 revealed yet another proposal for legislation limiting capital

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[27] Other examples are indicated in Surrey, "Definitional Problems in Capital Gains Taxation," *Tax Revision Compendium, Committee on Ways and Means, November 16, 1959,* 1203, 1211 (footnote 26):

> "For example, World War II 5-year amortization under Internal Revenue Code of 1939, sec. 124, added by 56 Stat. 849 (1942), left the asset a capital asset; under Korean war 5-year amortization, the asset became an ordinary asset to the extent of the excess of amortization over ordinary depreciation, sec. 1238; 5-year amortization of grain storage facilities under sec. 169 permits capital gain on the sale of the facility; rapid depreciation under sec. 167(b) leaves the asset a capital asset. Sec. 1239 prescribes ordinary income treatment for sales of depreciable property between shareholder and corporation in certain family settings; sec. 707(b)(2) is a similar provision relating to sales between a partnership and a partner.
>
> "In addition, the Commissioner has attempted to meet this general problem by limiting the amount of the depreciation deduction through a definition of useful life that takes account of the probable sale of the assets and through a measure of salvage value that takes account of the value at sale. See *Hertz Corporation* v. *United States* —, F. 2d — (3d Cir. 1959)."

gains treatment on the sale of depreciable business property:

"Under existing law, administration of the depreciation provisions is being hampered by the attempts of some taxpayers to claim excessive depreciation before disposing of their property. If gain from the sale of depreciable personal property were treated as ordinary income, the advantage gained in claiming excessive depreciation deductions would be materially reduced and the taxpayer's judgment as to the useful life of his property could more readily be accepted. Accordingly, I recommend that consideration be given to a change in the law which would treat such gain as ordinary income to the extent of the depreciation deduction previously taken on the property." (The Budget of the United States Government for the Fiscal Year ending June 30, 1961, page M11; Congressional Record, January 18, 1960, page 583.)

The proper forum for the arguments advanced by the Treasury in the case at bar is Congress, not the courts. The many thorough studies by legislative committees[28] and others[29] on possible changes in the depreciation and

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[28] See, for example, *The Federal Revenue System: Facts and Problems 1959, Materials Assembled by the Committee Staff for the Joint Economic Committee, Congress of the United States,* Joint Committee Print, 86th Congress, 1st Session, pages 45-66, 67-82; *Tax Revision Compendium, Committee on Ways and Means, November 16, 1959,* pages 793-931, 1193-1299.

[29] These include the examination of proposals for *statutory* action in the precise area here involved:

"Short lived property may well need specific statutory treatment to distinguish 'service life,' 'economic life,' salvage

capital gains provisions of the present Internal Revenue Code point the way for Treasury action through the accepted procedure—the legislative process.

A Treasury regulation is proper if it implements the law or if it explains or clarifies its meaning or if it facilitates its administration. But a regulatory provision is improper and invalid if, in the guise of any such purpose, it contradicts the clear intention of Congress. When the Treasury issues a regulation to the effect that depreciation is not allowable with respect to good will (Reg. Sec. 1.167-(a)-3), the regulation is valid and enforceable despite the fact that the statute does not itself except good will from the coverage of the statute. Congress was not trying to encourage the write-off of good will so that the taxpayer might go out and buy more good will. The provision on good will is thus consistent with Congressional intention.

But the new "useful life" definition in Reg. Sec. 1.167 (a)-1(b) represents an attempt to write into the Internal Revenue Code, by administrative fiat, a provision which Congress rejected—a section which is in direct contravention of the clear intent and purpose of Congress, and which should therefore be declared a nullity.

(Footnote 29 continued)

or sales proceeds, etc. *Cf. The Hertz Corp.* v. *United States,* 165 F. Supp. 261 (D. Del. 1958), appeal pending; *Evans* v. *Commissioner,* 59-1 USTC ¶ 9208, 3 AFTR 2d ¶ 59-415 (9th Cir. 1959)."

(American Bar Association, Section of Taxation, 1959, Program and Committee Reports to be Presented at the Twentieth Annual Meeting of the Section to be held August 20-25, 1959, Miami, Florida, Report of the Committee on Depreciation and Amortization, page 38, footnote 14.)

To summarize our position on this principal issue in the case, we have first shown that for 35 years prior to the enactment of Section 167 of the 1954 Code, the term "useful life" was defined as the physical or inherent functional life of the property (*i.e.*, the life of the property for general business purposes); that there is no evidence of Congressional intent to change that meaning when Congress enacted Section 167 of the 1954 Code; and that although defendant appears to be attacking plaintiff's interpretation of that section, in truth defendant is seeking to accomplish through this Court what it has failed to accomplish through Congress—the amendment of Section 1231.

II.

UNDER SECTION 167(b)(2) OF THE 1954 CODE (THE DECLINING BALANCE METHOD) SALVAGE VALUE IS INHERENT IN THE COMPUTATION OF DEPRECIATION AND IS NOT IMPOSED AS A LIMITATION UPON THE AMOUNT ALLOWED.

Not only is the Commissioner here attempting to impose a new definition of useful life, but he suggests another avenue of attack. He is saying, in effect, that if the taxpayer in this case is entitled to use the double declining balance method of depreciation applicable to assets with a useful life of three or more years, the Commissioner should be entitled to impose a dollar limit—the 1956 regulations' new concept of salvage value—at which the taking of depreciation must stop.

Not only is there no support in the 1954 Code for this position, but the Congressional history of the depreciation provisions of the 1954 Code contradicts the Commissioner's position—as does the logic of the declining balance method.

First, as to the logic of the method: Under Section 167 (b)(2) of the 1954 Code, the rate of depreciation under this method is twice the rate applicable under the straight-line method. If an asset has a ten-year useful life, under the straight-line method a 10% rate of depreciation would be applied so that the asset would be completely written off in ten years. However, at the end of that ten-year period there would be some salvage value representing a small percentage of the original value of the asset. Thus, it is logical that under the straight-line method the Commissioner should take the position that the taxpayer ought *first* to deduct from cost (or other basis) salvage value—the junk value the asset will have at the end of its useful life—and *then* take a deduction for depreciation equal to 10% of the value of the asset remaining.

But, by definition,[30] the double *declining balance* method is applied to the full cost of the asset in the first year, and thereafter to an ever-declining balance. Thus, in the case of an asset costing $1,000, having a useful life of ten years, the taxpayer would, for the first year, apply a 20% rate (double the straight-line rate) to the full cost of the asset, but thereafter, each year, the taxpayer would

[30] The salvage value is not deducted from the basis prior to applying the rate. . . ." (Senate Report, page 201, 3 U.S.C. Cong. & Adm. News [1954] 4836.)

apply the 20% rate to the undepreciated balance—to $800 the second year, to $640 the third year, to $512 the fourth year, etc. However, since the depreciation rate is applied always to a diminishing figure, there will remain at the end of the asset's useful life a balance which, as recognized by Congress, represented salvage value. Thus, at the end of the tenth year, under the declining balance method, there would remain, in the example given, an undepreciated balance of $107.38.

The logic of the declining balance method results inevitably in an undepreciated balance so representing salvage *no matter what the length of the useful life or the rate of depreciation.* Deductions of any percentage (less than 100%) of a declining balance can never result in depreciation equal to cost.

The American Institute of Accountants had no doubt about the fact that salvage value under the 1954 Code provisions is not a limitation in the declining balance method. The Institute laid the point expressly before the Senate Finance Committee during the pre-enactment consideration of the depreciation provisions of the 1954 Code. On April 19, 1954, the Institute's Committee on Federal Taxation filed with the Senate Finance Committee its Recommendation No. 20 on H.R. 8300, as follows:[31]

> "20. Section 167(b)(2): Attention is called to the fact that by reason of *the elimination of the factor of salvage value in the computation of the declining-balance method,* the resulting initial amount of deprecia-

[31] Senate Hearings, page 1314.

tion may be considerably more than twice what is allowed under the straight-line method." (Emphasis added.)

With the advice of the American Institute of Accountants before them, the Senate Finance Committee and Congress saw fit not to impose a salvage "stop" in the declining balance method. The Committee clearly expressed the Congressional intent at page 201 (3 U.S.C. Cong. & Adm. News [1954] 4856) of the Senate Report:

> "The salvage value is not deducted from the basis prior to applying the rate, since under this method [the declining balance method] at the expiration of useful life there remains an undepreciated balance *which represents salvage value.*" (Emphasis added.) [32]

The lack of necessity to superimpose a special salvage value limitation in the declining balance method is as logical as it is well-documented. Congress imposed a natural and simple mathematical safeguard against abuse of declining balance depreciation—the only one it deemed necessary—by restricting the application of the method to assets with a life of three years or more to prevent any possibility of a 100% write-off.

Thus, at page 29 (3 U.S.C. Cong. & Adm. News [1954] 4659) of the Senate Report, the Senate Finance Committee said:

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[32] The same intention is evidenced by references in the same report (page 27, 3 U.S.C. Cong. & Adm. News [1954] 4657) to an "automatically" left "unrecovered residual" and an "automatic residual" in the declining balance method.

"*Restriction of declining-balance rate on short-lived*[33] *assets.*—The use of the 200 percent declining-balance rate in the case of short-lived properties would result in extremely fast write-offs. For example, in the case of an asset with a 2-year service life, the doubling of the 50-percent straight-line rate would be equivalent to expensing the cost[34] in the year of acquisition. These properties would retain substantial value and could be resold subject to capital gain rates.

"To prevent unrealistic deductions and resulting tax avoidance, your committee has provided that the liberalized methods be made available only with respect to assets with useful lives of 3 or more years."

Thus, the Senate Finance Committee was saying two things[35] which are highly pertinent here:

FIRST: Section 167 (c), in the form reported to the Senate by its Finance Committee (which was identical in all respects material to this case with the provision finally

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[33] If Congress's view of "useful life" were the same as the Commissioner's, would not the stylistic variant "short-lived" have been, instead, "briefly-held" or some similar phrase?

[34] In the District Court, the defendant argued, astonishingly (Brief for the Defendant, page 40), that the Committee really meant "expensing the cost *less salvage*" and baldly stated that "The fact that the Committee does not spell this out in this particular paragraph is insignificant." (Emphasis added.)

[35] The Third Circuit was highly selective, in its opinion below (R. 138-39), in the references to the committee reports which it permitted itself. Its opinion contains no consideration—or even mention—of the Senate Finance Committee's statements from pages 29 and 201 (3 U.S.C. Cong. & Adm. News [1954] 4659 and 4856) of the Senate Report above quoted.

enacted into law) ought not to be so written as to permit the 200% declining balance rate to be applied in the case of assets which have a life of only two years (or less) because this would result in *unrealistic* deductions. The Committee was clearly saying that in the case of an asset which has a useful life of three years or more, a 100% write-off is impossible, since the most that can be written off is 66-2/3% the first year (in the case of an asset with a three-year life—the minimum life required) and, subsequently, 66-2/3% of the remainder.

SECOND: The Committee was emphasizing that in the case of an asset with a *two*-year life, the application of the 200% rate would mean that the cost of the asset would be *completely* written off—expensed—the first year. Indeed, the Committee reiterated its intention at pages 202-203 (3 U.S.C. Cong. & Adm. News [1954] 4838) of the Senate Report by saying:

> "The limitation was further applied to property with a life of 3 or more years to prevent unreasonable accumulation of depreciation allowances in the case of property with a relatively short life. Under the declining balance method an asset with a 2-year life and thus a 50 percent straight-line rate would be charged off 100 percent in the first year if this limitation did not apply."

But this could not be so if the Committee were contemplating that salvage value should represent a limitation upon depreciation under the declining balance method. If any such limitation had been assumed or contemplated by the Committee, it would have been saying, instead, that the ap-

plication of the 200% declining balance method to an asset with a two-year life would mean the writing off during the first year of 100% of the cost *except for the salvage value* of the asset. But since salvage value as a limitation was not in contemplation, the Committee concluded—as it would not otherwise have needed to conclude—that the way to *avoid* 100% write-off the first year was to limit the application of the 200% declining balance method *to assets having a useful life of at least three years.*

Perhaps the Commissioner would prefer the salvage value limitation to the three-year limitation—but Congress preferred the three-year limitation. Certainly, the Commissioner is not now entitled to have both.[36]

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[36] As pointed out in Graves, "Depreciation Problems," *The Journal of Accountancy* 43, 46 (October, 1956):

> "One of the features of the declining-balance method is that salvage value does not enter into the computation of depreciation allowances when that method is used. Since the Code states specifically that depreciation allowances computed under that method are to be treated as reasonable allowances, it would appear that an asset could be depreciated below salvage value. That this may have been the intent of Congress is indicated by the recognition of the Congressional committees that *the mechanics of the method result in an ultimate salvage value because the depreciation allowances are not sufficient to provide for complete recovery of basis at the end of the estimated life of an asset. However, the regulations provide that an asset cannot be depreciated below salvage value under any method. This provision is not unreasonable in itself but there seems to be no authority for it in the Code.*" (Emphasis added.)

This quotation was omitted by defendant in its opening Third Circuit brief below when it quoted from the Graves article (brief, page 43).

Buttressing the legislative history in unmistakable fashion is the Commissioner's own recognition and admission that salvage value is to be disregarded when the declining balance method is used. In Treasury Department Form 2106 (reproduced in full at page 88 herein), issued by the Internal Revenue Service in October, 1956 for use in connection with income tax returns, and dealing particularly with automobile expenses, the following items appear:

> "40. Purchase price of present car.
>
> "41. Less estimated salvage value.[1]
>
> "[1] Salvage value is the estimated resale or trade-in value of the vehicle, determined at the time of purchase. If declining balance method of depreciation is used, *disregard salvage value* in computing depreciation." [Emphasis added.]

There could hardly be a clearer interpretation of the 1954 Code on the point under discussion than the last sentence of the footnote—an interpretation issued after enactment of the 1954 Code, after promulgation of the depreciation regulations here involved and after the close of the last of the three taxable years here under review. Nor can it be said that the Commissioner meant merely that salvage value was not to be deducted first, but was to be used as a limitation beyond which depreciation was not to go; the language chosen by the Commissioner was unmistakable—the taxpayer is told to "*disregard*" salvage value if he uses the declining balance method of depreciation.

Indeed, in the depreciation regulations originally proposed by the Commissioner on September 28, 1954[37]—shortly after enactment of the 1954 Code on August 16, 1954—but later withdrawn in favor of the regulations here in issue, there was no hint of either the new definition of salvage which appears at Reg. Sec. 1.167(a)-1(c) of the final regulations (Appendix A, *infra*, pages 111-112), or of the provision of the final regulations that "While salvage is not taken into account in determining the annual allowances under this method [the declining balance method], in no event shall an asset (or an account) be depreciated below a reasonable salvage value" (Reg. Sec. 1.167(b)-2(a), Appendix A, *infra*, page 113).

In the case at bar the Commissioner attempts to sustain his new position that without something more than the automatic residual to cover salvage value a taxpayer might recover, by deductions for depreciation, almost the full cost of an asset and then sell the asset in a favorable market at a price which brings him more than salvage value.

To this a series of answers presents itself:

(1) The taxpayer must pay a tax out of any profit thus realized.

(2) He need pay only a capital gains tax because Congress rejected the recommendation that such profit be taxed as ordinary income, and chose instead to apply only the capital gains tax in order to encourage the earlier sale of depreciable assets, and the purchase of new assets, with attendant advantages for the economy.

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[37] Federal Register, September 28, 1954, Volume 19, Number 188, pages 6229-34.

FORM 2106 (REV. OCT. 1956)

U. S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE

WORKSHEET FOR USE OF TAXPAYER CLAIMING LOCAL TRANSPORTATION, TRAVEL, OR OUTSIDE SALESMAN EXPENSES INCURRED AS AN EMPLOYEE

1. TAXABLE YR.

2. YOUR NAME AND ADDRESS

3. NAME AND ADDRESS OF EMPLOYER IN WHOSE EMPLOYMENT EXPENSES INCURRED

4. If, as an employee, you were required to travel and incur business expenses incident thereto, or to incur transportation or outside salesman expenses during the taxable year, furnishing the information called for in this form will aid in determining the correct deduction for such expenses in computing adjusted gross income on page 1 of your return.

Any expenses claimed must be substantiated and must belong in one or more of the four classes described below. After carefully reading these descriptions, check the box or boxes opposite the class of expenses which you are entitled to claim. **Attach this form, when completed, to your return.**

☐ A. **Transportation expenses** (whether or not reimbursed by your employer) - These expenses consist only of actual transportation costs, including tips, for local travel in connection with your employment. Note that the cost of commuting between your residence and place of business is a personal expense and is NOT DEDUCTIBLE.

☐ B. **Travel expenses while away from home** (whether or not reimbursed by your employer) - "Home" is defined as your place of business, post of duty, or station. These expenses include tips and the cost of meals and lodgings incurred while away from home overnight.

☐ C. **Other business expenses for which you were reimbursed by your employer** - These may include such items as reimbursed expenses incurred in entertaining customers, paying commissions to other salesmen, etc. If these other business expenses were ordinary and necessary but were NOT reimbursed by your employer, they cannot be deducted here in computing adjusted gross income, but may be claimed as miscellaneous itemized deductions on your return if you elect not to use the standard deduction.

☐ D. **Outside salesman expenses** (whether or not reimbursed by your employer) - An "Outside salesman" is a full-time employee engaged principally in soliciting business for his employer elsewhere than at the employer's business premises. In addition to travel and transportation expenses, an outside salesman can deduct other ordinary and necessary business expenses.

5. BRIEFLY DESCRIBE NATURE OF OCCUPATION, BUSINESS, OR PROFESSION

6. TERRITORY COVERED, OR TEMPORARY LOCATION

NUMBER OF DAYS AND NIGHTS AWAY FROM HOME ON BUSINESS DURING TAXABLE YEAR

7A. DAYS

7B. NIGHTS

SCHEDULE OF DEDUCTIBLE TRANSPORTATION, TRAVEL OR OUTSIDE SALESMAN EXPENSES

8. Local bus, taxi, streetcar, etc., fares	$
9. Deductible automobile expenses *(Item 32 on other side of form)*	
10. Railroad, airplane, boat, etc., fares	
11. Meals and lodging while away from home overnight	
12. Other expenses, if reimbursed by your employer	

15. ARE RECORDS KEPT OF ALL EXPENSES CLAIMED?

☐ YES ☐ NO *(If answer is "No," how were expenses determined?)*

16. WERE YOU REIMBURSED BY YOUR EMPLOYER FOR ANY EXPENSES?

☐ YES ☐ NO *(If "Yes," enter Amount: $ ________ .)*

(This amount must be included in gross income.)

4. If, as an employee, you were required to travel and incur business expenses incident thereto, or to incur transportation or outside salesman expenses during the taxable year, furnishing the information called for in this form will aid in determining the correct deduction for such expenses in computing adjusted gross income on page 1 of your return.

Any expenses claimed must be substantiated and must belong in one or more of the four classes described below. After carefully reading these descriptions, check the box or boxes opposite the class of expenses which you are entitled to claim. **Attach this form, when completed, to your return.**

☐ A. **Transportation expenses** (whether or not reimbursed by your employer) - These expenses consist only of actual transportation costs, including tips, for local travel in connection with your employment. Note that the cost of commuting between your residence and place of business is a personal expense and is NOT DEDUCTIBLE.

☐ B. **Travel expenses while away from home** (whether or not reimbursed by your employer) - "Home" is defined as your place of business, post of duty, or station. These expenses include tips and the cost of meals and lodgings incurred while away from home overnight.

☐ C. **Other business expenses for which you were reimbursed by your employer** - These may include such items as reimbursed expenses incurred in entertaining customers, paying commissions to other salesmen, etc. If these other business expenses were ordinary and necessary but were NOT reimbursed by your employer, they cannot be deducted here in computing adjusted gross income, but may be claimed as miscellaneous itemized deductions on your return if you elect not to use the standard deduction.

☐ D. **Outside salesman expenses** (whether or not reimbursed by your employer) - An "Outside salesman" is a full-time employee engaged principally in soliciting business for his employer elsewhere than at the employer's business premises. In addition to travel and transportation expenses, an outside salesman can deduct other ordinary and necessary business expenses.

5. BRIEFLY DESCRIBE NATURE OF OCCUPATION, BUSINESS, OR PROFESSION

6. TERRITORY COVERED, OR TEMPORARY LOCATION

NUMBER OF DAYS AND NIGHTS AWAY FROM HOME ON BUSINESS DURING TAXABLE YEAR

7A. DAYS	7B. NIGHTS

SCHEDULE OF DEDUCTIBLE TRANSPORTATION, TRAVEL OR OUTSIDE SALESMAN EXPENSES

8. Local bus, taxi, streetcar, etc., fares	$
9. Deductible automobile expenses *(Item 32 on other side of form)*	
10. Railroad, airplane, boat, etc., fares	
11. Meals and lodging while away from home overnight	
12. Other expenses, **if reimbursed by your employer**	
13. All other expenses, **if you were an outside salesman**	
14. **Total expenses deductible in computing adjusted gross income**	$

15. ARE RECORDS KEPT OF ALL EXPENSES CLAIMED?
☐ YES ☐ NO *(If answer is "No," how were expenses determined?)*

16. WERE YOU REIMBURSED BY YOUR EMPLOYER FOR ANY EXPENSES?
☐ YES ☐ NO *(If "Yes," enter Amount: $ ____________)*
(This amount must be included in gross income.)

17. STATE METHOD OR BASIS OF REIMBURSEMENT

18. SIGNATURE

See Reverse

COMPUTATION OF ALLOWABLE EXPENSES ON AUTOMOBILE OR OTHER VEHICLE USED PARTLY FOR BUSINESS

If an automobile or other vehicle was used for business transportation or travel, the following information should be furnished from actual records.

TOTAL OF ALL AUTOMOBILE EXPENSES FOR YEAR *(Exclusive of depreciation)*		THE PORTION OF TOTAL AUTOMOBILE EXPENSES DEDUCTIBLE IS COMPUTED AS FOLLOWS	
19. Gas and oil	$	27. Total mileage during taxable year	MILES
20. Lubrication and washing		28. Portion of this mileage applicable to business	MILES
21. Repairs *(Itemize on separate sheet and attach)*		29. Percentage of car use applicable to business: *(Item 28 divided by item 27. - If other method of computing this percentage was used explain on a separate sheet and attach.)*	%
22. Tires, supplies, etc. *(Itemize on separate sheet and attach)*			
23. Garage and parking		30. Deductible automobile expenses *(Item 26 times item 29)*	$
24. Insurance		31. Deductible depreciation *(Item 33, col.(h))*	
25. Other *(Itemize on separate sheet and attach)*		32. **TOTAL DEDUCTIBLE AUTOMOBILE EXPENSES** *(Item 30 plus item 31. Enter also in item 9 on other side of form)*	
26. TOTAL	$		

DEPRECIATION

	MAKE AND STYLE OF VEHICLE (a)	DATE ACQUIRED (b)	BASIS *(See NOTE below)* (c)	AGE WHEN ACQUIRED (d)	DEPRECIATION ALLOWED IN PRIOR YEARS (e)	METHOD OF COMPUTING DEPRECIATION (f)	RATE (%) OR LIFE *(Years)* (g)	DEPRECIATION DEDUCTIBLE FOR THIS YEAR (h)
33.			$		$			$

NOTE: If vehicle was acquired for cash only or by trade-in of another vehicle which was not used in business, determine the basis by completing only Items 40 through 43 below. If it was acquired by trade-in of another vehicle previously used in business, determine the basis by completing Items 34 through 45. (The basis for depreciation must be recomputed each succeeding year.)

Old Car Traded in	34. Total mileage accumulated on old car at time of trade-in	MILES	35. Portion of this mileage applicable to business		MILES
	36. Percent of old car use applicable to business *(Item 35 divided by Item 34)*. If other method of computing this percentage was used, explain on a separate sheet and attach.				%
	37. Purchase price of old car	$;	Times percent shown in Item 36		$
	38. Less: a. Amount allowed on trade-in	$;	Times percent shown in Item 36	$	
	b. Total depreciation claimed or allowed on old car			$	$
	39. Gain or *(loss)* on business portion of car traded in *(Difference between Items 37 and 38)*				$
	40. Purchase price of present car.				

23. Garage and parking		*times item 29)*	$
24. Insurance		31. Deductible depreciation *(Item 33, col.(h))*	
25. Other *(Itemize on separate sheet and attach)*		**32. TOTAL DEDUCTIBLE AUTOMOBILE EXPENSES** *(Item 30 plus item 31. Enter also in item 9 on other side of form)*	
26. **TOTAL**	$		

DEPRECIATION

	MAKE AND STYLE OF VEHICLE (a)	DATE ACQUIRED (b)	BASIS *(See NOTE below)* (c)	AGE WHEN AC-QUIRED (d)	DEPRECIA-TION ALLOWED IN PRIOR YEARS (e)	METHOD OF COMPUTING DEPRECIATION (f)	RATE (%) OR LIFE *(Years)* (g)	DEPRECIATION DEDUCTIBLE FOR THIS YEAR (h)
33.			$		$			$

NOTE: If vehicle was acquired for cash only or by trade-in of another vehicle which was not used in business, determine the basis by completing only Items 40 through 43 below. If it was acquired by trade-in of another vehicle previously used in business, determine the basis by completing Items 34 through 45. (The basis for depreciation must be recomputed each succeeding year.)

Old Car Traded in	34. Total mileage accumulated on old car at time of trade-in	MILES	35. Portion of this mileage applicable to business		MILES
	36. Percent of old car use applicable to business *(Item 35 divided by Item 34)*. If other method of computing this percentage was used, explain on a separate sheet and attach.				%
	37. Purchase price of old car	$;	Times percent shown in Item 36		$
	38. Less: a. Amount allowed on trade-in	$;	Times percent shown in Item 36	$	
	b. Total depreciation claimed or allowed on old car			$	$
	39. Gain or *(loss)* on business portion of car traded in *(Difference between Items 37 and 38)*				$
Present Car	40. Purchase price of present car.				
	41. Less estimated salvage value 1/				
	42. Difference between items 40 and 41				
	43. Item 42 times percent shown in Item 29				
	44. Less gain or plus *(loss)* on trade-in of previous vehicle *(Item 39)*				
	45. Basis of present car for computing depreciation for taxable year.				$

1/ Salvage value is the estimated resale or trade-in value of the vehicle, determined at the time of purchase. If declining balance method of depreciation is used, disregard salvage value in computing depreciation.

FORM **2106** (REV. 10-56)

U. S. GOVERNMENT PRINTING OFFICE : 1956 O - 108047

(3) Such profit—if and when obtainable—results from *something which has no connection with depreciation: the state of the market.* Should the taxpayer be required to forecast the state of the market for goods which he may sell after a period of years, the length of which period he cannot prognosticate because of admittedly unpredictable factors (R. 42, 108)?[38]

True, depreciation deductions over the full useful life of an asset plus salvage are not permitted to total more than original cost. And just as it is substantially easier to estimate the full useful *life* of an asset than it is to estimate the length of time a given taxpayer will *use* that asset before selling it, something of the same considerations make it much easier to estimate *salvage*—scrap, junk or residual physical—value than to estimate what the asset will bring, after the unknown period of use, when it is sold by reason

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[38] In its opening brief to the Court of Appeals below (pages 28-29, footnote 9), the defendant frankly admitted:

> "It is true . . . that this recovery might be improved somewhat by the fact that a resale of the asset at an earlier date would result in a resale price higher than estimated salvage value. The amount of such recovery on the resale is *purely conjectural, however, based as it necessarily is upon the saleability of the asset, the conditions of the particular business and business conditions in general. In any event, a recovery through higher resale is not a recovery through depreciation. . . .*" (Emphasis added.)

We note two things: First, the defendant admits that the direction of Reg. Sec. 1.167(a)-1(c) that salvage value be estimated as the amount realizable upon sale is a direction to guess at a "purely conjectural" amount. Moreover, if recovery through resale is not recovery through depreciation, what can sales proceeds have to do with the basic theory of depreciation?

of unpredictable factors. The state of the second-hand market in that asset may itself dictate the date of sale. A new invention may dictate the date of sale. Ordinary wear and tear—real depreciation—may dictate the date of sale. Or unexpected competition, or unexpected weather, or an unexpected strike, or a variety of other factors may dictate the date of sale.

The sum of the deductions for depreciation plus salvage value equals recovery by depreciation. What the taxpayer happens to receive upon the *sale* of the asset is not recovery by depreciation. Congress itself has recognized that the taxpayer's sales proceeds may be substantially in excess of salvage value.[39] If such proceeds are higher than the asset's

[39] That sales proceeds are not equivalent to salvage value appears clearly in the legislative history of Section 117(a) of the Revenue Act of 1938 (52 Stat. 447, 500), which excluded depreciable business assets from the category of capital assets so as to permit taxpayers to obtain ordinary (instead of capital) losses on sales of such assets. At pages 34-35 of House Report No. 1860, 75th Cong., 3rd Sess., accompanying the Revenue Bill of 1938, the House Ways and Means Committee stated (1939-1 CB [Part 2] 752-53):

"Suppose that X, a manufacturer, purchased in 1932 a large machine, at a cost of $50,000. At the time of acquisition and installation in his plant, the machine had an estimated useful life of 10 years. X was therefore allowed an annual deduction from gross income for depreciation on the straight-line method of one-tenth of the cost, or $5,000, with respect to this machine. Assume that in 1938, when the machine has been in use for six years, a new and improved type of machine is introduced, the installation of which would materially reduce X's costs of production. X has, however, recovered only 60 per cent of the cost of the old machine through the annual deduction for depreciation. Let it be further assumed that X could sell the old machine to Y, another manufacturer, for $7,500, which is only 15 per cent of its cost to X, *but is materially in excess of its junk or salvage value.*" (Emphasis added.)

depreciated cost, they are subject to a capital gains tax. If they are lower than the asset's depreciated cost, the taxpayer may take the loss as an offset against ordinary income. If the availability to the taxpayer of this result displeases the Commissioner of Internal Revenue, the source of his displeasure is Congress, not the taxpayer. The latter merely uses the doors intentionally left open for him by a Congress intent upon giving him this benefit for the sake of the economy as a whole.

Regulations under the 1939 Code for many years before 1954 described depreciation as "excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence." (Reg. 118, Sec. 39.23[1]-1). The present regulations are just as clear. They state that the depreciation allowance "shall not reflect amounts representing a mere reduction in market value." (Reg. Sec. 1.167[a]-1[a]).

Upon analysis, it appears that the Commissioner's new theory of depreciation embodies the philosophy of providing an allowance for the decline in the market value of an asset during the period in which it happens to be used by a particular taxpayer. Under this theory, the cost of the asset, less the amount for which he anticipates selling it, constitutes the taxpayer's basis for depreciation. This basis is to be written off during the period in which he holds the asset. To repeat: the sum to be depreciated, under the new regulations, is essentially the difference between two market value figures—the first derived when the taxpayer purchases the asset and the second when he sells it. To be sure, the 1956 regulations state that depreciation

computation is to be made foresightedly, using only an informed estimate of the probable holding period and sales proceeds.[40] But into such an estimate of future events, inaccuracies, many of them serious, are bound to creep.

Depreciation is an accounting concept and not a market concept. It measures, and is intended by Congress to measure, value decline only in terms of the erosion of usefulness by exhaustion, wear and tear. For example, depreciation certainly goes on and is allowed even in periods of extraordinary demand when used assets appreciate in market value. The Commissioner's holding period-sales proceeds approach in the case at bar may provide an arithmetical measure of something, but it is not a measure of the exhaustion, wear and tear of the asset.[41]

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[40] For a view as to how this provision is actually being administered in the field by the Internal Revenue Service, see Romak, "How Agents Are Applying the New Salvage and Accelerated Depreciation Rules," 8 *Journal of Taxation* 204 (April, 1958).

[41] "It is true that a machine which has been installed and used for a few weeks is already second-hand and could be sold for perhaps not more than half its cost, although it may still have a service life of 10 years. But the machine is not being held for sale; it is being held for use, and if only 3 months have expired of its total service life of 10 years, then only 1-40 of its value to its owners has expired, and 39-40 of its value to them remains. The fact that its sale value might be less has nothing to do with the case. In other words, depreciation measures the exhaustion of service capacity in the assets; it does not measure the fluctuations of market prices of those or similar assets. It is well understood that if any question of the sale of the properties should arise, their current market value would become very important; but information on that subject would naturally be sought for outside the books of account." Thomas Henry Sanders (Professor of Accounting, Graduate School of Business Administration, Harvard University), *Industrial Accounting, Control of Industry Through Costs* 147 (New York: McGraw-Hill Book Company, Inc., 1929).

The concept of depreciation for federal income tax purposes has always carried with it the accepted proposition that the taxpayer should not recover more than cost. Under the double declining balance method, a taxpayer can *never* recover more than cost. He may sell the asset in a favorable market and realize a profit—perhaps a profit which brings him double his cost. But this is not "recovering" his cost through depreciation. This is realization of a profit which was anticipated by Congress as an incentive to induce the taxpayer to sell earlier than he might normally otherwise sell. *This profit, if the market is high, is realizable under any and all methods of depreciation, however liberal or however meager.*

In summary, the logic of the declining balance method and the legislative history of the depreciation provisions of the 1954 Code combine to show that there is a "built-in" amount—always an undepreciated balance—under that method "which represents salvage value" (Senate Report, page 201, 3 U.S.C. Cong. & Adm. News [1954] 4856), and that no other limitation was intended.

III.

THE COMMISSIONER'S NEW DEFINITION OF USEFUL LIFE AND HIS IMPOSITION OF A SALVAGE VALUE LIMITATION ON THE USE OF THE DECLINING BALANCE METHOD OF DEPRECIATION ARE INAPPLICABLE TO THE TAXABLE YEARS IN ISSUE.

We have demonstrated above that the Commissioner's new definition of "useful life" was invalid because it did not conform to Congressional intention. Because the Dis-

trict Court below held (R. 129) that the regulatory provisions containing the new definition could be applied prospectively only (*i.e.*, from and after their promulgation in June, 1956), we wish to discuss the question of retroactive application of those provisions. We are, however, denying the validity of those provisions, either prospectively or retroactively.

Section 7805(b) of the 1954 Code (and its predecessor, Section 3791(b) of the 1939 Code) provides:

> "The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."

As will be shown, the decisions of this Court and the legislative history of that provision both preclude application of the new definition of useful life in this case because it was not promulgated until after the taxable years here in issue.[42]

A regulation containing a substantive change from a prior regulation which was issued under the same or similar statutory authority may not be given retroactive effect. *Helvering* v. *Griffiths,* 318 U.S. 371, 397 (1943); *Helvering* v. *R. J. Reynolds Tobacco Co.,* 306 U.S. 110, 116-17 (1939);

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[42] The regulations here involved were proposed on November 11, 1955 (20 F.R. 8454-64). Thus, during the 36-month period (ended March 31, 1956) involved in this case, the Commissioner's new regulations on "useful life" were not public knowledge *even in proposed form* until more than five-sixths of the entire three-year period (and almost two-thirds of the last taxable year) had elapsed. And, of course, the regulations were not issued in final form until almost three months after the close of that last taxable year.

Aluminum Company of America v. *United States*, 123 F. 2d 615, 620 (3d Cir. 1941); *Commissioner* v. *Monarch Life Ins. Co.*, 114 F. 2d 314, 323 (1st Cir. 1940).

The facts relevant to this discussion may be quickly summarized as follows:

"From 1918 through part of 1956, the general depreciation provisions of the various revenue acts and codes and the regulations thereunder remained almost identically the same; the term "useful life" which appeared in the depreciation regulations was consistently interpreted by the courts, by the Treasury Department and by the business community to mean the inherent physical life of the depreciable property; the basic statutory depreciation provision was reenacted in the 1954 Code on August 16, 1954; and the regulations under the 1939 Code were continued in effect by "stop-gap" regulations (T.D. 6091, 1954-2 CB 47). Only after the end of the taxable years in issue were regulations issued which attempted to change that established meaning of "useful life"."

The similarity between this case and the facts in *Helvering* v. *Griffiths*, 318 U.S. 371 (1943), is striking. There, as here, the basic statutory provisions and the regulations had not been changed despite several reenactments of the statute over a long period of time. In *Griffiths*, the latest reenactment, the 1939 Code, took place during the taxable year in which were distributed the stock dividends whose taxability was there in issue. After the end of the taxable year, as here, final regulations were issued under the 1939 Code corresponding to the regulations under the Revenue

Act of 1938, which, as here, had been continued in effect by "stop-gap" regulations. In 1940, those final regulations were amended to enlarge the taxability of stock dividends, and, it was argued by the Commissioner, the amended regulations made the stock dividends distributed in 1939 subject to tax.

This Court held:

(1) the subsequent regulations were not to be relied upon as an indication of Congressional intention; and

(2) the subsequent regulations could not be applied to a taxable year which ended prior to the promulgation of such regulations.

In reaching that second conclusion, this Court pointed out (318 U.S. at 395) that it had in *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939), denied retroactive effects to amendments to valid regulations which had survived reenactment of the statute, and went on to say, at page 397:

> "... We would think it unquestionable that in this case the Treasury could not retroactively amend the Regulation to the prejudice of the respondent, except for the Government's assertion that it should be disregarded upon the authority of *Helvering* v. *Hallock*, 309 U.S. 106, 121, note 8, and that, in any event, under § 3791 (b) of the Internal Revenue Code the Secretary or Commissioner must be held to have authority in any case to make a retroactive amendment of a Regulation."

The "Government's assertion" was summarily dismissed. The Court stated:

> "This Court has denied retroactive effects to amendments to valid Treasury Regulations which have survived reenactment of the statute, even in the absence of any affirmative indication that the subject-matter of the statute and Regulation was called to the attention of Congress." (318 U.S. at 395.)

And the Court rejected the Commissioner's claim that under Section 3791(b) of the 1939 Code, the Commissioner could amend the regulation in question retroactively, stating, after a careful review of the legislative history of that provision (footnote 49, at 318 U.S. 397-399):

> "[Section 3791(b)] is the final statute of a series intended to *relieve the Treasury* from the effect of the view that its administrative rulings, like court decisions, must have retroactive as well as prospective operation.
>
> " * * * * *
>
> "Thus it appears that this legislation [Section 3791 (b)] *was intended to permit escape from the retroactive effects of administrative action by the Treasury*, rather than to increase its power to make retroactive rulings. *Cf.* 69 Cong. Rec. 7881." (Emphasis added.)

Section 3791(b)—identical to Section 7805(b) of the 1954 Code—was thus viewed as permitting limitations on the retroactive application of regulations rather than as requiring retroactive application. Accordingly, it was not necessary to reconsider the holding in the *Reynolds Tobacco Co.* case, where the Court had denied retroactive application.

The holding of the *Griffiths* case as to the effect of Section 3791(b) does not conflict with the decision of this Court in *Automobile Club of Michigan* v. *Commissioner of Internal Revenue,* 353 U.S. 180 (1957). There, this Court upheld the Commissioner's retroactive revocation of a private tax exemption ruling issued to an automobile club. The Court was careful to point out that the applicability of *regulations* was not involved, and emphasized the distinction between that case and the present case by pointing out, at page 185:

> "This is thus not a case of ' . . . administrative construction embodied in the regulation[s] . . . ' which, by repeated re-enactment of § 101 (9), ' . . . Congress must be taken to have approved . . . and thereby to have given . . . the force of law.' *Helvering* v. *R. J. Reynolds* [*Tobacco*] *Co.,* 306 U.S., at 114, 115."

Indeed, the last-cited case (306 U.S. 110) is a key authority establishing that the Commissioner may not retroactively apply the regulatory limitations here in issue. In discussing the predecessor of Section 7805(b), this Court there pointed out that—as in the instant case—a longstanding regulation had received Congressional approval by the reenactment of the governing statute in successive revenue acts, and stated (306 U.S. at 116):

> "The question is whether the granted power [in Section 3791(b) of the 1939 Code] may be exercised in an instance where, by repeated reenactment of the statute, Congress has given its sanction to the existing regulation."

This question the Court answered in the negative.

Section 7805(b) of the 1954 Code does not permit retroactive application of the regulatory limitations here in issue under the circumstances of this case.

Our conclusion is directly supported by the decision in *Aluminum Co. of America* v. *United States,* 123 F. 2d 615 (3d Cir. 1941). Resolution of a foreign tax credit issue hinged on the proper interpretation of a provision of the Revenue Act of 1926. The court found that the statutory formula in that Act was in all material respects the same as that in the corresponding section of the 1921 Act. The court pointed out that for nine years (1921-1930) the Treasury Department had administered the statute in question consistently with the taxpayer's position, and affirmed judgment for the taxpayer, stating:

> "Of course, neither Treasury Regulations nor administrative practice are determinative of the Law . . . But, they take on significance when Congress, during the period in which they obtain, reenacts the statutory provision, so interpreted, without making substantial change therein. That is precisely what occurred with respect to Sec. 238(e) of the Revenue Act of 1921 upon three separate occasions. So that what the Treasury had uniformly evidenced as being its understanding of the meaning of Section 238(e), Congress impliedly confirmed as being correctly interpretative of the legislative intent. *Helvering* v. *Winmill,* 305 U.S. 79, 83, 59 S. Ct. 45, 83 L. Ed. 52; *Hassett* v. *Welch, et al., Executors,* 303 U.S. 303, 312, 58 S. Ct. 559, 82 L. Ed. 858; *Old Mission Portland Cement Co.* v. *Helvering,* 293 U.S. 289, 293, 294, 55 S. Ct. 158, 70 L. Ed. 367; *United States* v. *Dakota-Montana Oil Co.,* 288 U.S. 459, 466, 53 S. Ct. 435, 77 L. Ed. 893." (123 F. 2d at 620.)

The court further stated:

> "Nor is the implied Congressional approval of the administrative practice to be disregarded, as the defendant suggests. . . . Whatever validity and effect the change in administrative enforcement of the tax credit provision may have had, and has, prospectively, it cannot operate retroactively and particularly not in view of the earlier well established administrative practice and the implied Congressional approval which that practice had recurrently received. What the Supreme Court said in *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110, 117, 59 S. Ct., 423, 427, 83 L. Ed. 536, is peculiarly apposite in this connection: 'It may be that by the passage of the Revenue Act of 1936 [26 U.S.C.A. Int. Rev. Acts, page 813 *et seq.*] [here the reenactments after 1932] the Treasury was authorized thereafter to apply the regulation in its amended form. But we have no occasion to decide this question since we are of opinion that the reenactment of the section, without more, does not amount to sanction of *retroactive* enforcement of the amendment, *in the teeth of the former regulation which received Congressional approval* by the passage of successive Revenue Acts including that of 1928.' (Emphasis supplied.)" (123 F. 2d at 620-21.)

On this branch of the argument, we may assume that when a tax statute is enacted which contains new provisions (such as the specialized depreciation methods introduced by Section 167 in 1954), it is to be expected that the ensuing administrative analysis by the Treasury will reveal specific problems which (so far as the legislative history indicates) the Congressional authors of the statute did not consider. So far as the words and the legislative

history of the new statute indicate, no intention to change the basic portion of the prior law is manifested. Faced with the necessity of administering the new legislation, the Treasury adopts regulations which are a departure from the regulations previously in force. The judiciary is then asked to say whether, in the light of the relative roles of the legislature and the executive, the Treasury's new departure is within the scope of fair comment on—fair interpretation of—the statute which the executive must administer. And a further question for the judiciary is whether, if the administrative comment or interpretation be deemed fair, the executive's new departure is of such degree that the permissible rule change should be applicable only to the future. It is our contention that under the facts of this case and the authorities cited above, the Commissioner's new conceptions of useful life and salvage value, promulgated in June, 1956, are so far a departure from the norm established by prior authority, practice, common understanding and Congressional re-enactments of the depreciation statute that the new conceptions should, if valid for any purpose whatever, have vigor only for periods after their issuance.

CONCLUSION.

In summary, plaintiff's position is that the testimony in this case, the legislative history of the 1954 Code and prior legislation, the decisions in tax cases directly in point, and the Commissioner's own rulings, all lead to these conclusions: (1) that the accepted meaning, for depreciation purposes, of the term "useful life" of an asset has always been, and under Section 167 of the 1954 Code still is, its business life and not the length of time it happens to be held by a particular taxpayer, and that the Commissioner's regulatory provision to the contrary is invalid; (2) that the useful life of plaintiff's vehicles being more than three years, plaintiff was entitled to depreciate them under the 200% declining balance method prescribed by Section 167 (b)(2) of the 1954 Code; (3) that under said double declining balance method, the taxpayer's depreciation deduction is not to be limited by salvage value, other than that inherent in the method, and that the Commissioner's regulatory provision to the contrary is invalid; (4) that, regardless of their validity, the Commissioner's regulatory provisions referred to in (1) and (3) above may not be retroactively applied to the years here in issue; and (5) that, accordingly, judgment for the defendant herein should be reversed, and that plaintiff should be entitled to a refund of $14,367.32 plus interest and costs, on the basis that plain-

tiff is entitled to depreciate its automobiles and trucks under Section 167(b)(2) of the 1954 Code without any limitation as to salvage value other than that inherent in the double declining balance method.

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APPENDIX A

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION

(a) *General rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of certain methods and rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) *Limitations on use of certain methods and rates.*—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

* * * * *

(f) *Basis for depreciation.*—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

* * * * *

(Int. Rev. Code § 167, 26 U.S.C.A. 1955 ed., § 167 [Supp., 1958].)

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gain and losses)), adjusted as provided in section 1016.

(Int. Rev. Code § 1011, 26 U.S.C.A. § 1011 [1955].)

SEC. 1012. BASIS OF PROPERTY—COST

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners

and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

(Int. Rev. Code § 1012, 26 U.S.C.A. § 1012 [1955].)

Sec. 1016. Adjustments to Basis

(a) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

*   *   *   *   *

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws.

*   *   *   *   *

(Int. Rev. Code § 1016, 26 U.S.C.A. 1955 ed., § 1016 [Supp., 1958].)

Sec. 1231. Property used in the trade or business and involuntary conversions

(a) *General rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business . . . exceed the recognized

losses from such sales [and] exchanges . . . such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months.

* * * * *

(b) *Definition of property used in the trade or business.*—For purposes of this section—

(1) *General rule.*—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months . . . which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year [or]

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . .

* * * * *

(Int. Rev. Code § 1231, 26 U.S.C.A. 1955 ed., § 1231 [Supp., 1958].)

Internal Revenue Code of 1939:

SEC. 117(j). *Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business.*

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation pro-

vided in section 23(l) held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . .

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business . . . exceed the recognized losses from such sales [and] exchanges . . . such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. . . .

* * * * *

(Int. Rev. Code § 117(j), 26 U.S.C.A. 1945 ed., § 117(j) [Supp., 1945].)

Treasury Regulations on Income Taxes (1954 Code):

§ 1.167(a)-1. *Depreciation in general.*—

(a) *Reasonable allowance.*—Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the prop-

erty as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and

there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167 (d)-1.

(c) *Salvage.*—Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage

in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

* * * * *

§ 1.167(b)-0. *Methods of computing depreciation*—

(a) *In general.*—Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property.

* * * * *

§ 1.167(b)-1. *Straight line method.*—

(a) *Application of method.*—Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience,

the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

* * * * * *

§ 1.167(b)-2. *Declining balance method.*—

(a) *Application of method.*—Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(f), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(b)(2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See Section 167(c) and § 1.167(c)-1 for restrictions on the use of the declining balance method.

* * * * *

§ 1.167(c)-1. *Limitations on methods of computing depreciation under Section* 167(b) (2), (3), *and* (4).—

* * * * *

(c) *Election to use methods.*—Subject to the limitations set forth in paragraph (a) of this section, the methods of computing the allowance for depreciation specified in section 167 (b) (2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) above, he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any property shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167(b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

APPENDIX B

(Colloquy at 100 Cong. Rec. [Part 7] 9599-9600, 83rd Cong., 2nd Sess., July 2, 1954.)

[On July 2, 1954, after the provisions of Section 167 had been reported to the Senate by the Senate Finance Committee (in form identical to the ultimately enacted language in all respects material hereto), the following colloquy took place on the floor of the Senate with respect to an amendment proposed by Senator Douglas.]

> "**Mr. Millikin:** . . . I believe, in view of our budgetary situation, no matter how desirable a 1-year write-off on farm machinery might be, the fact of the matter is that very little farm machinery *exhausts itself* in a year's time. . . .
>
> "**Mr. Douglas:** Mr. President, since many Members are present in the Chamber who were not present when the amendment was originally explained, I hope I may be forgiven if I summarize it briefly.
>
> "The amendment gives the farmers the option of charging off in a given year the cost of new farm machinery purchases up to 25 percent of the gross income of the farmer.
>
> "This would make it easier for the farmers to purchase farm equipment, since even with the accelerated rates which have been provided in the bill the amount which is now permitted to be written off annually is relatively small, since the *physical life* of a tractor is placed at 10 years, and the *physical life* of many other items of farm equipment is placed at more than

10 years, with an average for all farm equipment of 15 years.

"**Mr. Daniel:** Mr. President, will the Senator yield?

"**Mr. Douglas:** I yield.

"**Mr. Daniel:** Am I to understand the Senator to mean by that statement that depreciation cannot be taken on a tractor, for instance, in a lesser period than 10 years?

"**Mr. Douglas:** Does the Senator mean under the proposal I am making?

"**Mr. Daniel:** No; under the present law, I understood farm machinery could be depreciated over a 5-year period at 20 percent a year.

"**Mr. Douglas:** I may say to the Senator from Texas that I have before me Bulletin F entitled 'Income Tax Depreciation and Obsolescence; Estimated Use for [*sic*] Lives and Depreciation Rates.' It was published by the United States Treasury Department, Bureau of Internal Revenue. On pages 12 and 13 are shown as I have stated the *physical lives* used as a basis for depreciation. In the case of tractors it is 10 years. In the case of rakes, it is 15 years; shredders, 15 years; farm mowers, 14 years; grain harvesters, 15 years; grain binders, 14 years.

"**Mr. Daniel:** I am asking only my question to obtain information.

"**Mr. Douglas:** I understand.

"**Mr. Daniel:** Because I have understood, and I have checked the matter with several Senators from agriculture areas, and they understand it to be true also, that even today it is possible to depreciate tractors and other farm machinery over a 5-year period, taking 20 percent a year.

"I should like to know if that is correct. If the Senator from Illinois cannot tell me, I wonder if anyone else can, because that information, I think, is very important in connection with the amendment.

"**Mr. Frear**: Mr. President, will the Senator from Illinois yield?

"**Mr. Douglas**: I shall be glad to yield, *but may I say that this is right 'out of the horse's mouth,' so to speak, right out of the sources of the Treasury, and the depreciation rates are based upon the estimated physical life of various units of farm equipment.* I should like to show the Senator from Texas and the Senator from Delaware this table.

"**Mr. Frear**: But I should like to say to the Senator, if he will yield—

"**Mr. Douglas**: Certainly.

"**Mr. Frear**: This is a guide for the internal revenue agent, when he analyzes or examines the returns. He does not have to use that formula. The general custom is to depreciate tractors at the rate of 20 percent a year.

"**Mr. Douglas**: I am not certain whether the Senator from Delaware is correct, but, if so, then the entire basis upon which the Bureau of Internal Revenue is supposed to act is thrown overboard, and the judgment of the individual agent is substituted for the rules laid down. While it is true that agents can use their judgment, and that the rules are not prescribed for use in every case, they are intended as a guide from which correct rates may be determined in the light of experience.

"**Mr. Frear**: That is correct.

"**Mr. Douglas**: The life of tractors is stated as 10 years; binders, 14 years to 5 [*sic*] years; grain har-

vester, 15 years. If these figures are not correct, we might as well throw the formula into the ashcan.

"**Mr. Frear**: May I ask the Senator the date of that formula?

"**Mr. Douglas**: *It was published in 1942, but was it [sic] given to us as currently correct by the staff of the Joint Committee on Internal Revenue Taxation. Unless we can get a disavowal from the Joint Committee on Internal Revenue Taxation, I assume these are the rates presently applicable.*

"**Mr. Frear**: They are not applicable in Delaware.

"**Mr. Douglas**: I think a member of the staff is on the floor, so if they wish to disavow this child, they may do so.

"I pause for a moment to wait for the disavowal of parentage to come. Not hearing any—

"**Mr. Millikin**: Mr. President, will the Senator from Illinois yield?

"**Mr. Douglas**: Does the Senator from Colorado wish to disavow it?

"**Mr. Millikin**: This material was supplied me by the staff. I have given the figures heretofore. *The present depreciation rate for farm machinery is an average of 6½ percent.*

"**Mr. Douglas**: That is what the Bureau says is the average, namely a 15-year period. This is stated in the table I have previously inserted in the RECORD.

"So, Mr. President, the statement of the Senator from Colorado happens also to be the statement of the Senator from Illinois, and I welcome the Greeks when they bear gifts, because they do it so infrequently.

"**Mr. Millikin**: I was not casting any aspersions on

either the Senator or the technical staff. *I am pointing out that the average is 6½ percent.*

"**Mr. Douglas:** That would be the average for 15 years. I may say that Mr. Oram, of the joint committee staff, has just called the Bureau of Internal Revenue. They state that a 5-year depreciation period for a tractor is very rare. A study by Mr. E. Callahan, an agricultural economist at Rutgers University, indicates that the actual life of large tractors is 8 to 15 years, and that of a small tractor is 5 to 12 years.

"**Mr. Frear:** I deny that that is the same as 6-½ percent.

"**Mr. Millikin:** I mentioned the 6-½ percent. If we double that under the acceleration provided in the bill it is 13 percent. The amendment of the Senator from Illinois adds a much larger percentage in 1 year, and there would be a loss of revenue of $550 million by the Senator's amendment." (Emphasis added.)

BRIEF FOR

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In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 283

THE HERTZ CORPORATION, A CORPORATION (SUCCESSOR BY MERGER TO J. FRANK CONNOR, INC., A CORPORATION), PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the District Court (R. 105–129) is reported at 165 F. Supp. 261. The opinion of the Court of Appeals (R. 131–139) is reported at 268 F. 2d 604.

JURISDICTION

The judgment of the Court of Appeals was entered on July 6, 1959. (R. 139–140.) The petition for writ of certiorari was filed August 6, 1959, and was granted on October 12, 1959. (R. 141.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254 (1).

QUESTIONS PRESENTED

1. Section 167(c) of the Internal Revenue Code of 1954 provides that the declining balance method of depreciation shall be available only in the case of property having a useful life of three years or more. Section 1.167(a)-1(b) of the Treasury Regulations on Income Taxes defines "useful life" as the period during which the property may be expected to be useful to the taxpayer in his business.

The first question is whether the statutory term "useful life" refers (as the Regulations declare) to the period that an asset is useful in the taxpayer's business, as differentiated from the period (which may or may not correspond) that it is economically useful. The answer determines whether taxpayer, a car rental firm, may depreciate cars which it holds, on the average, for slightly more than two years under the declining balance method.

2. Whether assets which are depreciable under the declining balance method (taxpayer's trucks and, if taxpayer is correct on Question 1, its cars as well) may be depreciated below a reasonable salvage value, the pertinent Treasury Regulations to the contrary notwithstanding.

3. If it be held in relation to Question 1 that "useful life" is validly defined in Section 1.167(a)-1(b) of the Treasury Regulations issued on June 11, 1956, but that such definition was a change from prior law (rather than a continuation of prior law, as the Commissioner contends), there is the further question whether the Regulations may be applied to taxpayer in relation to the taxable years here involved.

STATUTES AND REGULATIONS INVOLVED

Sections 167, 1011, 1012, 1016 and 7805 of the Internal Revenue Code of 1954 and Sections 1.167(a)-1, 1.167(b)-0, 1.167(b)-1, 1.167(b)-2 and 1.167(c)-1 of the Treasury Regulations on Income Taxes (1954 Code) are set forth in the Appendix, *infra*, pp. 56-63.

STATEMENT

This action is brought for refund of income taxes allegedly due the taxpayer for its fiscal years ending March 31, 1954, 1955 and 1956. The refunds claimed involve the propriety of deductions for depreciation claimed by taxpayer. The findings of fact of the District Court are incorporated in its opinion (R. 105-129) and may be summarized as follows:

Taxpayer J. Frank Connor, Inc., a New Jersey corporation organized in 1947, was merged into taxpayer Hertz Corporation, a Delaware corporation, on July 5, 1956, pursuant to a statutory merger under the applicable laws of Delaware and New Jersey. The latter corporation thus became entitled to file the claims for refunds which are the subject of this appeal. (R. 105.)

At all material times, taxpayer was engaged in the business of renting and leasing automobiles and trucks without drivers. This business was carried on in the State of New Jersey. As used in the business, "renting" is a term applied to the hiring of vehicles by salesmen, executives, engineers and tourists on a short-term basis at stipulated rates per mile, per hour, or per day. The term "leasing" is applied to the

contract hiring of vehicles on a relatively long-term basis, such as for a year or longer. (R. 105–106.)

During the years here involved, taxpayer had in operation a preventive maintenance program to insure the safety and good mechanical condition of its cars. While taxpayer owned the vehicles, they were subject to a constant system of inspection, including inspections at 1,000, 2,000, 3,000 and 6,000 miles. The cars were regularly serviced and were lubricated every 1,000 or 1,500 miles, mileage records being kept with respect to each car. A factor which influenced taxpayer's decision to buy and sell automobiles was whether it was operating a substantial part of its fleet. (R. 106–107.)

Other factors influencing taxpayer's decision to buy or sell cars included the activities of taxpayer's competitors, mechanical changes, strikes and lockouts, climatic conditions and whether the country was at war or at peace. If taxpayer's competitors had a demand for certain types of cars, taxpayer would have to supply similar types to keep up with such demand. If mechanical changes for which there was a demand were introduced (*e.g.,* automatic transmissions), these had to be supplied; at the same time, taxpayer had to maintain vehicles with a conventional transmission to satisfy the desires of customers preferring such vehicles. Strikes, lockouts, and work stoppages might also delay the sale of vehicles inasmuch as they could not be sold until replacements were available. Severe storms sometimes increased the demand for taxpayer's cars and thus necessitated a larger fleet. When the Newark Airport was reopened after it had been closed

down in 1952, taxpayer experienced an unanticipated increase in its business in that location and expanded its fleet by sixty cars within one year. Another factor influencing taxpayer's decision to sell automobiles was its financial situation. Cars were sold on one occasion to meet a bank loan, on another to pay off notes, and on another to pay the rent. None of these contingencies was predictable in advance. (R. 107–108.)

Under the influence of the factors mentioned, the periods during which taxpayer used automobiles and trucks in its renting and leasing business varied considerably not only during the taxable years here involved but throughout its business life. The average holding period of automobiles sold during the fiscal years ended March 31, 1954, March 31, 1955, and March 31, 1956, was 26.17 months. The average holding period of automobiles sold during the entire nine-year period of taxpayer's operation was 29.36 months.

The average holding period of trucks sold during the fiscal years 1954–1956, inclusive, was 38.89 months. The average holding period for such trucks during the entire nine-year period was 48.26 months. All averages were computed on a weighted basis, giving effect to the number of cars sold in each year. (R. 108.)

Certified public accountants, partners in the firms of Ernst & Ernst, Price Waterhouse & Company, and Arthur Anderson & Company, testified that the term "useful life" has consistently meant the economic or business life of the asset in whatever hands, not its life in the hands of a particular taxpayer. They also

testified that the useful life of automobiles used for business purposes is four years.

Mr. Jacobs, president of the Hertz Corporation, testified that the car rental industry was still in a young and formative stage and has grown rapidly during the past ten years. In view of the youth and growth of the industry, he stated, business policies are necessarily fluid and important policies must be changed. According to Mr. Jacobs, the factors influencing the Hertz Corportion present the same problems to others in the industry, including J. Frank Connor, Inc., because there is substantial competition and such competition has increased during recent years. (R. 108–109.)

The Hertz Corporation owns and operates a car rental business in approximately 170 cities and licenses such operations in some 650 other cities. An important factor governing its purchase and sale of automobiles is the state of economic conditions. Newness is far from the sole factor in determining the length of time an automobile is used and, if economic conditions warranted, it would be disregarded. Its decisions on the purchase and sale of automobiles are influenced by the desire to meet competition, by the inability to offer replacement automobiles during a period of war, by mechanical innovations such as automatic transmissions and by strikes and lockouts in the plants of automobile manufacturers. At the present time, it is faced with the problem of the small, lower-priced cars; if the demand for such cars increases, Hertz would have the probiem of disposing of its present fleet without substantial losses in order to

replace it with smaller, low-cost cars. Hertz does not know now when it will sell the cars that it presently owns, since none of the factors influencing its purchase and sale policy are predictable. For practical purposes it is uneconomic to use an automobile for business purposes for a period longer than four years. (R. 109-110.)

Over the years, the term "useful life" in the field of business and accounting has come to be regarded as the business life of an asset whether or not it passed from one owner to another. It meant the total period for which the asset was useful for business purposes. This was not only the general accounting understanding of the term but the uncontradicted testimony of the certified public accountants was that, prior to the promulgation of the 1956 Regulations on depreciation by the Commissioner of Internal Revenue, their experience with representatives of the Internal Revenue Service was that the depreciation rate was computed on the basis of the aggregate business life of the asset regardless of changes in ownership. (R. 110.)

In its income tax returns for the years ended March 31, 1954, March 31, 1955, and March 31, 1956, taxpayer claimed depreciation on its automobiles on the basis of a four year life at a rate of 30% for each of the first two years and 20% for each of the last two years. On its trucks taxpayer claimed depreciation at a uniform rate on the basis of a five-year life for heavy duty trucks and a four-year life for other trucks.[1] Taxpayer paid all taxes shown on its re-

[1] With respect to automobiles and trucks acquired after December 31, 1953, and prior to April 1, 1954, however, deprecia-

turns. The return for the taxable year ended March 31, 1955, was examined by the Internal Revenue Service and approved as filed except for a minor adjustment not here relevant. In that return, taxpayer claimed depreciation on the basis of a four-year useful life for automobiles, a five-year useful life for heavy duty trucks and a four-year useful life for other trucks. (R. 110–112.)

On September 14, 1956, taxpayer filed claims for refund of income taxes paid for the fiscal years ended March 31, 1954, and March 31, 1955, and on September 17, 1956, it filed a claim for refund of income taxes paid for the fiscal year ended March 31, 1956. In these claims for refund, taxpayer elected, in accordance with Section 1.167(c)–1(c) of the Treasury Regulations on Income Taxes issued under the Internal Revenue Code of 1954, to use the declining balance method in computing depreciation on its automobiles and trucks for the fiscal years enumerated, using a rate of 200% of the straightline rate in lieu of the deductions claimed on the original tax returns. No action having been taken upon such claims for a period of six months, this suit for refund followed.[2]

The District Court held that by 1954 the term "useful life" had come to mean the entire physical life of an asset for business purposes but that Congress,

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tion was claimed at the rate of 2 or 3¢ per mile, in the case of automobiles, and 3¢ per mile, in the case of trucks. (R. 111.)

[2] While the District Court made no specific finding as to the filing of these claims for refund and the election to take depreciation under the declining balance method contained therein, the facts appear in the Stipulation of Facts (pars. 9, 10, 14) filed by the parties and are therefore undisputed. (R. 96–97.)

in enacting the Internal Revenue Code of 1954, intended to change that concept. The court accordingly concluded that the term "useful life" now means the useful life of the asset in the hands of the taxpayer and that Section 1.167(a)-1(b) of the Treasury Regulations so defining the term is valid. Notwithstanding this conclusion (which would mean that the taxpayer was not entitled to use the declining balance method of depreciation with respect to its automobiles because they did not have a useful life of more than three years as required by Section 167(c) of the Code), the District Court further held that taxpayer was entitled to depreciation allowances based upon the declining balance method for the reason that the Treasury Regulations in question were not issued until after the close of the taxable years here involved and could not be applied retroactively to those years.

With respect to the taxpayer's trucks, it was conceded in the District Court that these items were held by the taxpayer for three years or more and thus had a useful life of at least three years under the interpretation of that term contained in the Regulations. Consequently, it was undisputed that the taxpayer was entitled to compute depreciation on these trucks under the declining balance method. The Government contended, however, that in accordance with Sections 1.167(a)-1(a) and (c), and 1.167(b)-2(a) of the Treasury Regulations, these trucks could not be depreciated below a reasonable salvage value. This contention was overruled by the District Court which held that salvage value was inherent in the declining balance method of depreciation and that the undepre-

ciated balance remaining at the end of useful life represented salvage value. (R. 112–129.)

On appeal by the Government to the Court of Appeals, the judgment of the District Court was reversed. The Court of Appeals, reviewing the judicial precedents, administrative practice, and expert opinion relied upon by the taxpayer, concluded that the accepted meaning of the term "useful life" has always been the period during which the asset is useful to the taxpayer in his business. This, it declared, was in accord with the fundamental concept of depreciation expressed by this Court in *United States v. Ludey*, 274 U.S. 295, and was supported by the legislative history of the 1954 Code. It followed from the Court of Appeals' conclusion as to the meaning of "useful life" that taxpayer was not entitled to compute depreciation on its automobiles under the declining balance method; they did not have a "useful life" of three years or more as required by the statute. (R. 134–138.)[3]

The court also ruled, so far as taxpayer's trucks are concerned (concededly, they may be depreciated under the declining balance method), that they might not be depreciated below a reasonable salvage value (the position expressed in the Treasury Regulations), On this point the court held that the congressional purpose in authorizing accelerated methods of depreciation was merely to change the timing but not the total amount of depreciation deductions. (R. 138–139.)

[3] On the Court of Appeals' view, of course, there is no question as to alleged retroactive application of the Regulations.

SUMMARY OF ARGUMENT

I

Taxpayer in this case, as in the companion cases, *Commissioner* v. *Evans,* No. 143, and *Massey Motors Inc.* v. *United States,* No. 141, this Term, is in the car rental business. It retains its cars for a period slightly in excess of two years and then disposes of them at substantial prices. The taxable years involved follow the enactment of the 1954 Code, and taxpayer seeks to avail itself of the provisions of that Code permitting the use of accelerated methods of depreciation. Specifically, it seeks to use the declining balance method of depreciation, which permits higher depreciation deductions in the earlier years of the useful life of the asset and lower deductions in the later years. (This is accomplished by depreciating the assets at a rate which is double the straight line rate and applying such rate to the cost or other basis in the first year and to the undepreciated balance remaining in each succeeding year.)

Under the provisions of the Code, however, the declining balance method is available only with respect to assets having a useful life of three years or more. Since taxpayer holds it cars only slightly in excess of two years, it must avoid this limitation. To this end, it asserts that useful life, for purposes of depreciation, does not mean the period during which it retains the cars (as the current Treasury Regulations explicitly provide) but, rather, their entire physical or economic life, which it alleges to be four years.

As argued in the Government's brief in the *Evans* case, depreciation is a method whereby a taxpayer is enabled to recover, tax-free, the net cost of an asset

(*i.e.,* the difference between purchase price and salvage value) during the years that it is useful to the taxpayer in his business. That is the teaching of this Court's decisions and those of the Courts of Appeals. And the objective of cost recovery cannot be realized unless "useful life" is deemed coextensive with the period during which an asset is useful to the taxpayer, as distinguished from the period during which it may prove useful to others who may thereafter acquire it.

This case illustrates the distortion which would otherwise result. Taxpayer lays down the initial premise, crucial to its position, that it may adopt a period of useful life (four years) which does not reflect its own practice, experience or expectation (use of automobiles for approximately two years). It then adopts a method of accelerating depreciation which Congress made available only for long-term (three or more years) assets. This, in turn, enables taxpayer to depreciate its cars 75 percent in two years' time. At this point, taxpayer sells the cars for sums which substantially exceed their depreciated value. This excess depreciation enhances deductions from ordinary income, taxable at 52 percent, and makes for capital gains taxable at only 25 percent.

Taxpayer agrees with the Government that Congress, in enacting the 1954 Code, intended no change in the concept of "useful life." Its efforts to show that pre-1954 decisions and administrative practice are consistent with its view that useful life means total physical life, *i.e.,* a period measured without regard to taxpayer's holding period, have no foundation. Both this Court's decisions and formal Treasury Regulations in effect for more than 35 years are directly to the contrary.

Moreover, in authorizing accelerated depreciation in 1954, Congress stated that it was approving a change in the timing of depreciation deductions, but not a change in the ultimate amount of such deductions. This objective can be achieved only if taxpayer is required to take depreciation based upon its own holding period.

II

Since taxpayer's trucks (as distinguished from its cars) had a useful life in excess of three years, taxpayer is entitled to depreciate them under the declining balance method. On this phase of the case, the issue relates to the role of salvage value when depreciation is computed under the declining balance method.

The applicable Regulations provide that, although salvage value need not be deducted initially in determining the annual allowances under the declining balance method, in no event may the asset be depreciated below the reasonable salvage value. In other words, a taxpayer may obtain maximum acceleration of depreciation, but salvage value, as under other methods, limits the ultimate amount of depreciation. Since this provision of the Regulations is entirely consistent with the 1954 legislation and with the general theory of depreciation, it must be sustained. Taxpayer's view that known or predictable salvage value may be ignored would permit an increase in the amount of depreciation deductions and a recovery in excess of cost.

III

If it be held in relation to Question 1 that "useful

life" is validly defined in the Treasury Regulations issued on June 11, 1956, as meaning "the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business," but that such definition was a change from prior law (rather than a continuation of prior law, as the Commissioner contends), there is a further question: Whether the Regulations may be applied to taxpayer in relation to the taxable years here involved, the fiscal years ending March 31, 1954, March 31, 1955 and March 31, 1956.

On this hypothesis, we argue, first, that the Regulations were not in fact retroactively applied to this taxpayer and, second, that in all events a retroactive application would be permissible.

Taxpayer did not elect to claim depreciation deductions under the declining balance method until its claims for refund were filed in September 1956. These claims followed by three months the promulgation of the Regulations in question. Indeed, the election to claim accelerated depreciation was made pursuant to other provisions of the same Regulations. Thus, in this case, the Regulations were applied prospectively.

Moreover, the Regulations were promulgated under "the very Act which determines * * * liability," *Helvering* v. *Reynolds,* 313 U.S. 428, 433, and retrospective application would be permissible in the absence of a showing of abuse of discretion. *Automobile Club* v. *Commissioner,* 353 U.S. 180. No such showing has been attempted. Furthermore, the change from prior law, if there was one, was made by the 1954 Code and not by the Regulations, which are merely declaratory.

ARGUMENT

I

UNDER THE 1954 CODE, AS UNDER PRIOR LAW, "USEFUL LIFE," FOR PURPOSES OF DEPRECIATION, MEANS THE PERIOD DURING WHICH AN ASSET IS USEFUL TO THE TAXPAYER. THE REGULATIONS SO PROVIDING ARE VALID.

This case, like the companion cases, *Commissioner* v. *Evans*, No. 143, and *Massey Motors, Inc.* v. *United States*, No. 141, this Term, involves issues as to the proper computation of depreciation allowances by a taxpayer engaged in the car rental business. Unlike the other two cases, the present suit arises under the Internal Revenue Code of 1954, and it involves the asserted right to use the declining balance method of depreciation. Despite these differences, the proper meaning to be given the term "useful life" (which is the basic problem in the *Evans* and *Massey* cases) is also fundamental here inasmuch as Section 167(c) of the 1954 Code (Appendix, *infra*, p. 57) limits the use of the declining balance method to assets having a useful life of three years or more. The Government's position is that since taxpayer holds its automobiles for an average period of approximately 26 months, it may not take accelerated depreciation under the declining balance method.[4]

Taxpayer argues, to the contrary, that "useful life" does not mean the period during which an asset is useful in taxpayer's business, but, rather, the period

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[4] A separate issue involving depreciation of taxpayer's trucks, which are concededly held for more than three years and are hence properly depreciable under the declining balance method, is treated under Point II, *infra*.

during which it may be useful in *any* business. In its elaborate argument on this point, taxpayer does not come to grips with what we conceive to be the basic principle enunciated by this Court in *United States* v. *Ludey,* 274 U.S. 295, and *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98:[5] That depreciation is allowed as a means whereby a taxpayer is permitted deductions in such amounts as will, together with its salvage value, enable him to recover his cost or investment in business property. Nor does taxpayer reconcile its contentions with the fundamental proposition, discussed at length in our brief in the *Evans* case, that this objective cannot be realized unless "useful life" is deemed coextensive with the period that the assets are useful to the taxpayer.[6]

Taxpayer's initial premise—that it may adopt a period of useful life which does not reflect its own practice, experience or expectation—enables it to postulate an artificially long period of useful life. That premise laid down, it then proceeds to adopt a method of accelerated depreciation (the declining balance method) which Congress made available in the 1954 Code in respect of long-term (useful life of three years or more) assets.

The declining balance method, it should be observed, permits a drastic measure of depreciation in the early years of useful life. Taxpayer here, invoking that

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[5] See, also, the opinion below, the opinion of the Fifth Circuit in *United States* v. *Massey Motors, Inc.*, 264 F. 2d 552, No. 141, this Term, and *Cohn* v. *United States*, 259 F. 2d 371 (C.A. 6th).

[6] We have served copies of our brief in the *Evans* case, which sets out our views on the meaning of "useful life," upon the taxpayers involved in the *Massey* case and the instant case.

method, depreciates 75 percent of the cost of automobiles within two years. It sells its automobiles at prices substantially in excess of their remaining depreciated value. The end result is that it obtains large depreciation deductions which are offset against ordinary income; the capital gains which are realized in consequence of its taking depreciation in inflated amounts are taxable at the far more favorable capital gains rates. The consequences are the same as those sought by the taxpayers in the two companion cases; the mechanics are somewhat different.

A. THE DECLINING BALANCE METHOD OF DEPRECIATION AS COMPARED WITH THE STRAIGHT LINE METHOD OF DEPRECIATION

In the companion cases, depreciation deductions are claimed under the straight line method, whereas in the instant case they are claimed under the declining balance method. This, as we shall point out, provides an opportunity for a more striking distortion of income—one which may best be understood if a brief comparison of the two methods is made.

Under the straight line method, the salvage value is first deducted from the cost or other basis of the asset and a uniform rate of depreciation measured by the useful life of the property is applied to the remainder during each year of such life. Under the declining balance method, on the other hand, no deduction for salvage value is required in the first instance and the taxpayer may depreciate the asset at a rate not to exceed double the straight line rate. This double rate is applied to the cost or other basis in the first year and then to the undepreciated balance remaining in each of the succeeding years.

To illustrate, a taxpayer holding an asset which has a cost basis of $2,000 and a useful life of four years would, under the straight line method, deduct the estimated salvage value of the asset at the end of four years and take depreciation deductions on the remainder at the rate of 25% per annum. Under the declining balance method, the taxpayer would not deduct salvage value at the outset. And he may apply depreciation to the cost or other basis, not at a rate of 25%, but at a rate of 50%. In the case of an asset costing $2,000, this would permit a depreciation deduction of $1,000 in the first year; in the second year, this rate is applied to the undepreciated balance of $1,000, resulting in a deduction of $500 for that year; in the third year, this rate would be applied to the remaining basis of $500, resulting in a deduction of $250; and so on.[7]

It may thus be seen that, under the declining balance method of depreciation, deductions may be claimed which total 75% of the cost of the asset in two years and 87½% of the cost in three years. This is in sharp contrast to the straight line method under which a uniform rate of 25% may be taken in each year. In recognition of these facts, Congress, when it authorized the use of the declining method as an optional method of depreciation in Section 167(b) of the 1954 Code (Appendix, *infra*, p. 56), also provided a limitation on the use of this method. This limitation is contained in Section 167(c) and provides that de-

[7] For purposes of simplicity, the ultimate application of salvage value has been disregarded in illustrating the method of computing declining balance depreciation. This problem is discussed *infra*, pp. 38–50.

clining balance depreciation may not be used unless the useful life of the asset is three years or more. It is the application of this limitation which is drawn in issue in this case, for it is established by the findings of the District Court, which were not challenged by the taxpayer, that the taxpayer's cars were held for a period averaging 26.17 months. (R. 108.) If the term "useful life" means the period during which the cars are held by the taxpayer, it follows that taxpayer is not entitled to use the declining balance method of depreciation. In order to overcome this obstacle, taxpayer argues that its cars have a physical business life of four years and that this is the crucial consideration. The taxpayer contends, in short, that it may compute its depreciation upon the basis of a four year life, although it knows that, on the average, it will be holding those assets for a period slightly in excess of two years.

B. THE TERM "USEFUL LIFE" HAS CONSISTENTLY MEANT THE PERIOD DURING WHICH PROPERTY IS USEFUL TO THE TAXPAYER

Although, as has been shown, there are significant differences between straight line depreciation (as used in *Evans* and *Massey*) and the declining balance method of depreciation sought to be applied to taxpayer's automobiles in the instant case, it is of course true that the concept of useful life remains the same irrespective of the method of computing the annual allowance. It should also be noted, at the outset, that the problem of interpretation of the term "useful life" presented by all three cases is somewhat unusual in that the useful life of the particular assets to the taxpayer does not coincide with their physical or

economic life. It is far more common, in the depreciation of business assets, that such assets are held to the end of their economic life and then disposed of—in which event, of course, there is no occasion for distinction between useful life in the taxpayer's business and economic life.

The fundamental concept of depreciation, as has been noted above and in our brief in *Evans* (pp. 15–16), was carefully explained by this Court in *United States* v. *Ludey, supra,* and *Detroit Edison Co.* v. *Commissioner, supra,* as a method whereby the recovery or replacement of the cost of an asset might be accomplished by annual deductions over "the useful life of the plant in the business" (*Ludey,* 274 U.S. at 301). A similar view has consistently been taken by other courts and by the Commissioner, and a like interpretation was adopted by Congress in enacting the 1954 Code. These matters are fully set forth in our brief in *Evans* (pp. 15–27) and need not be restated here.

Taxpayer attempts to show that the Commissioner, in several cases before the Tax Court and the Board of Tax Appeals, as well as in a few cases in the lower federal courts, has taken a seemingly inconsistent position. Before turning to these cases and to certain isolated statements of the Commissioner which allegedly show inconsistency, we shall undertake an examination of taxpayer's position as developed in its brief.

1. Taxpayer seemingly does not openly disagree with this Court's statement of the nature of depreci-

ation contained in *United States* v. *Ludey, supra.*[8] If it be accepted that depreciation represents a method for the recovery of cost by annual depreciation deductions, it follows, we submit, that the objective cannot be attained under the view advanced by taxpayer. In the case of an automobile costing $2,000 held by a taxpayer for two years, but having an asserted business life of four years, the taxpayer would, under the straight line method, be able to recover only 50% (25% each year) of the depreciable cost (cost less salvage value); under the declining balance method, it could recover only 75% of cost. In neither instance would the objective of full recovery of cost be realized, no matter what the actual cost involved.

That full recovery is the true objective of the depreciation deductions is abundantly illustrated not only by this Court's decisions, but by the consistently uniform language of Treasury Regulations for over 35 years. It is significant that the language used by this Court in *Ludey* (pp. 300–301), as set forth in our brief in *Evans* (pp. 15–16), is almost an exact paraphrase of Article 161 of Treasury Regulations 65, promulgated under the Revenue Act of 1924.[9] Lest

[8] We note in passing that it does attempt to dismiss Mr. Justice Brandeis' much-cited exposition of the concept of depreciation as *dictum*. (Br. 25–26.) This is surprising in light of the fact that this Court remanded *Ludey* for a correct determination of the depreciation deductions to be made, holding that the Commissioner's computation was incorrect.

[9] As pointed out in our brief in *Evans* (p. 20), this language was repeated without change in all Regulations to and including Regulations 103, promulgated under the Internal Revenue Code of 1939. The taxpayer's reliance on the state-

there be any doubt on this point, it is noteworthy that Article 164 of Treasury Regulations 45 (1920 ed.), promulgated under the Revenue Act of 1918, provided:

> The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made * * *.

Article 165 similarly provided:

> The capital sum to be replaced should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. * * *

These provisions appeared in substantially identical form in all subsequent Regulations.[10] Obviously, if

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ment of the Court of Appeals in *Evans* pointing to the omission of the words "in the business" following the words "useful life" in Treasury Regulations 118 is without significance. As demonstrated in the Government's brief in *Evans* (pp. 21-22), this omission has been correctly explained by the Court of Appeals in *Massey* as attributable to an amendment of the statute in 1942 permitting depreciation of "property held for the production of income" as well as property used in business. In the light of that amendment, the Regulations could no longer refer simply to the "useful life of the property in the business" and were necessarily changed to "useful life of the depreciable property" in order to encompass both types of property.

[10] See Articles 164 and 165 of Treasury Regulations 62, 65 and 69, promulgated under the Revenue Acts of 1921, 1924 and 1926; Articles 204 and 205 of Treasury Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932; Articles 23(l)-4 and 23(l)-5 of Treasury Regulations 86, 94 and 101, promulgated under the Revenue Acts of 1934, 1936, and 1938; and Sections 19.23(l)-4 and 19.24(l)-5 of Treasury Regulations 103, Sections 29.23(l)-4 and 29.23(l)-5 of Treasury Regu-

the capital sum to be replaced or recovered is the cost of the property (or, as now, the cost or other basis) and this sum is to be replaced or recovered by being charged off in annual installments over the useful life of the property, the term "useful life" cannot conceivably mean physical business life of the asset to the original taxpayer *and* to those who purchase the asset from him. If that were so, the original taxpayer could never recover his cost or other basis in any case in which he normally sold the property before its business life was exhausted.

Thus, although none of the Revenue Acts prior to the 1954 Code mentioned useful life, but merely provided for a "reasonable allowance" for depreciation (*e.g.*, Section 23(l) of the 1939 Code), it is clear that by judicial decision and administrative regulation depreciation has consistently been treated as a method whereby deductions may be taken annually in order that such deductions, plus the salvage value, shall be equal to the cost or other basis of the property at the end of its useful life to the taxpayer.

2. The basic fallacy underlying taxpayer's position is demonstrated by its postulating a state of facts under which two taxpayers in the same type of business buy identical assets at the same time and same price, which are subject to the same wear and tear, but which are held or estimated to be held for differing periods. (Br. 21.) Taxpayer professes astonishment that, under the Government's view of useful life, these two taxpayers would be depreciating identical assets

lations 111, and Sections 39.23(l)-4 and 39.23(l)-5 of Treasury Regulations 118, all promulgated under the Internal Revenue Code of 1939.

at differing rates, though the wear and tear is the same. But this very illustration demonstrates the error of taxpayer's position. It is not wear and tear in the abstract which is to be recovered through depreciation deductions; it is the wear and tear measured by the difference between the cost of the asset and its estimated salvage value when it is to be resold. Thus, if one of the hypothetical taxpayers holds his asset for two years and the other holds his asset for four years, the differences are significant. In the case of the first, the salvage value at the end of two years will be somewhat larger and the wear and tear significantly less than in the case of the taxpayer holding the asset for twice that period. The amount each is to recover by depreciation will thus necessarily be different and will be reflected not only by different rates of depreciation, but by *differing bases* for depreciation. If each taxpayer were permitted to depreciate at the same rate, different amounts of depreciation would be allowable for each, and either one or the other would fail to recover his cost less salvage value.

Let us assume that the assets in question cost $2,000 each and that the salvage value at the end of two years is $750, and at the end of four years is $250. In the case of the taxpayer holding the asset for two years, the amount to be depreciated is thus $1,250; for the other it is $1,750. If we were to adopt the hypothesis advanced by taxpayer and allow depreciation measured by the four year period for each, the first taxpayer would depreciate $1,250 at the rate of 25%, or $312.50 per year for two years, while the second would depreciate $1,750 at the same rate, or $437.50 per year for four years. The first taxpayer would thus recover only $625 in depreciation deductions plus

$750 salvage value, for a total of $1,375, as contrasted with a cost basis of $2,000, while the second taxpayer would recover his entire cost through depreciation plus salvage value. Under the Government's position, on the other hand, the first taxpayer would use a useful life of two years and would thus be entitled to depreciate his $1,250 at 50%, or $625 per year, thus realizing a recovery of $1,250 through depreciation which, with the salvage of $750, would equal his entire cost; the second taxpayer would compute depreciation on a four year useful life as above and would also recover his entire cost. On this basis, both taxpayers would recover their cost in the property through depreciation.

3. Taxpayer refers (Br. 22–24) to a number of decisions of the Board of Tax Appeals and of the Tax Court which purportedly show that assets were permitted to be depreciated over a period of years longer than that during which the particular taxpayer held such assets. None of these decisions, however, contains any statement inconsistent with the position taken by the court below or by the Government here. In most of them, the period of useful life was held to be a question of fact and was determined by the court without explanation of the reasons for its determination. In two cases, where some explanation was given, it appears clear that there is no conflict with the views here expressed.

In *Kurtz* v. *Commissioner,* 8 B.T.A. 679, the evidence showed that trucks were used by the taxpayer for "about" four years. Relying on this approximation, the Board merely held that the Commissioner's determination of a useful life of five years was reasonable.

In *General Securities Co.* v. *Commissioner,* decided April 9, 1942 (1942 P-H B.T.A. Memorandum Decisions, par. 42,219), affirmed on other grounds, 137 F. 2d 201 (C.A. 6th), the taxpayer's president testified that, under the facts there existing, the automobiles in question could not have had anticipated lives of more than three years in the taxpayer's business. The Board accordingly held that a useful life of three years was reasonable and noted that there was no question involved of any earlier depreciation.

The weight and effect to be given these decisions was properly appraised by the court below when it stated (R. 136):

> As regards judicial interpretation—we have been cited to a number of Board of Tax Appeals and Tax Court decisions. However, the issue was not squarely presented nor was any theory of useful life formulated therein; rather, the questions posed in the cases were treated as factual in nature. Thus they are of little, if any, use to us as precedents.

Taxpayer also refers (Br. 26-27) to the decision of the court below in *Philber Equipment Corp.* v. *Commissioner,* 237 F. 2d 129, and to the brief filed on behalf of the Commissioner in that case. The issue there was not depreciation, but whether the proceeds from the sale of the assets in question were entitled to capital gains treatment. In determining that the proceeds were entitled to be taxed as capital gains, the court noted, in passing, that the equipment would be held "for a period substantially less than its useful life." (237 F. 2d at p. 130.) This decision, and par-

ticularly the quoted language, was brought to the attention of the Court of Appeals in its consideration of the instant case, and its significance was aptly characterized as follows (R. 136):

> It was also noted that *Philber Equipment Corp.* v. *Commissioner of Internal Revenue,* 237 F. 2d 129 (C.A. 3, 1956), utilized the term useful life in the sense contended for by Hertz. However, a close reading of that opinion indicates that its use of the term may well support either contention. Moreover, the use of the term was not essential to the holding nor was that issue litigated on appeal.

Taxpayer also relies (Br. 29) on language contained in the decision in *Hillard* v. *Commissioner,* 31 T.C. 961, now pending on appeal to the Court of Appeals for the Fifth Circuit, in which the same capital gains issue was presented. The Tax Court's passing reference to the fact that the cars there involved were held (p. 969) "for a comparatively minor portion of their useful life" can hardly be deemed relevant in view of the fact that no issue of depreciation was there presented.[11]

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[11] The same observations are applicable with respect to taxpayer's emphasis (Br. 40–41) on the Commissioner's brief on appeal in that case, in which reference is again made to the fact that the cars were held for a period less than their "normal" useful life. Taxpayer fails to note (1) that the brief stated (p. 19, fn. 5) that depreciation had been allowed by the Tax Court on an incorrect theory; and (2) that the Commissioner filed a supplemental brief in the Court of Appeals in which it was expressly stated that any references in the main brief to useful life of the cars was not to be construed as an approval of the language of the Tax Court on that subject.

4. Taxpayer also asserts that the Commissioner's own pronouncements are at variance with the views here expressed and with the decision below. (Br. 32-45.) It relies, first, upon O.D. 845, 4 Cum. Bull. 178 (1921), but in doing so ignores the plain language involved. That ruling defines "useful life" as the period during which an asset may be useful "for the purpose for which it was acquired"; yet the taxpayer asserts that this could include the period of its general usefulness for business purposes by others as well as the taxpayer. But "the purpose for which it was acquired" can hardly include the use of the asset by others and must, by its terms, be limited to the use of the asset by the particular taxpayer.

Taxpayer also claims inconsistency in Rev. Rul. 108, 1953-1 Cum. Bull. 185 and Rev. Rul. 54-229, 1954-1 Cum. Bull. 124. (Br. 37-38.) These rulings were not concerned with problems of depreciation, but with the proper treatment of the proceeds of automobiles sold after being used in a rental business. They merely note that the automobiles were leased and then sold, and that the leases were for a period less than the "normal" useful lives of the vehicles in question. If we substitute the word "expected" for "normal", there can be no doubt as to the significance of these references, for it is apparent that the Commissioner was referring merely to the useful life which might normally be expected in the absence of the special circumstances presented in the situations before him. The taxpayer, moreover, is patently in error in asserting that if the Commissioner was there interpreting "useful life" as he does

now there would have been no need for the rulings because there would have been no capital gains issue. Useful life and salvage value, as the Regulations plainly recognize, are to be *estimated* by the taxpayer (Treasury Regulations, Section 1.167(a)-1, Appendix, *infra*, p. 59). Since all depreciation methods involve estimation, it can never be assumed that no gain will result upon the ultimate disposition of an asset at the end of useful life.

Lastly, taxpayer refers to various isolated passages quoted from Bulletin "F," Bureau of Internal Revenue (Revised January 1942), as supporting its contentions. (Br. 32-36.) Pertinent provisions of that Bulletin are set out in our main brief in *Evans* (pp. 24-25), to which the Court is respectfully referred. Suffice it to note for present purposes that the title page of the Bulletin warns all taxpayers that the information set forth therein must be applied to the particular facts of the case; that the useful lives therein contained are averages only and are not prescribed for any individual case; and that such lives are merely guides for determining the correct information "in the light of the experience of the property under consideration and all other pertinent evidence." Moreover, as the court below also noted (R. 136-137), the Bulletin, on page 2, states that the proper depreciation allowance is that amount which should be set aside annually in order that the total deductions, plus salvage value, will equal the cost or other basis "at the end of the useful life of the property in the business". The Bulletin is thus phrased in the same

language as Regulations dating back to 1924; it specifically links useful life to the business, not to the physical or economic life.

5. Along similar lines, taxpayer refers to certain briefs filed by the Commissioner which allegedly express inconsistent views. (Br. 39–43). These asserted discrepancies, upon proper examination, prove to be non-existent.

Thus, the brief filed on behalf of the Commissioner in *Penn.* v. *Commissioner,* 199 F. 2d 210 (C.A. 8th) was concerned with the proper allowance for depreciation of a building as claimed by the life tenant. The Commissioner asserted that useful life in that context could not be equated with the life expectancy of the life tenant. This was obviously correct, inasmuch as the ownership of the building was divided between the life tenant and the remainderman. The life tenant could not be permitted to recover the entire cost of a building of which he was not the sole owner and which could be expected to be useful for business purposes not only for the period of the life tenancy, but for a period beyond such term as well.

The brief filed by the Government in *Highland Hills Swimming Club* v. *Wiseman* (W.D. Okla.), decided September 5, 1958 (59–1 U.S.T.C. par. 9284), affirmed 272 F. 2d 176 (C.A. 10th), is also in accord with the Commissioner's view of useful life. The passages excerpted from that brief are taken wholly out of context. In that case, as the brief plainly states in portions ignored by taxpayer, it was contended by the Commissioner that the lease of the swimming pool involved must be regarded as one of indefinite dura-

tion, because not negotiated at arm's length, and that the taxpayer therefore could not depreciate the swimming pool over the artificial term of the lease, but must allocate such depreciation over the useful life of the property. The conclusions of law entered by the District Court adopt that argument.

The Government's brief in *Shainberg* v. *Commissioner*, 33 T.C., No. 28, from which taxpayer quotes an excerpt (Br. 43–44), was addressed to the matter of estimating the useful life of taxpayer's buildings. The issue in that case was whether taxpayer was required to treat its buildings as composite units or whether he might take depreciation on separate components and use different measuring periods (so many years for plumbing installations, so many years for electric wiring, etc.). It was assumed by both parties—and correctly so, on the facts of the case—that useful life in the business and economic life would be the same, for there was no intimation that taxpayer would not retain the buildings for the duration of their physical life. The only question was as to the property to be depreciated, *i.e.*, whether the buildings were to be treated as units or to be broken down into components, each of which would have its own estimated useful life.

6. Taxpayer erroneously states (Br. 47) that the Government does not cite, in support of its position, any cases or rulings decided or published before the enactment of the 1954 Code. Throughout the litigation, we have relied upon this Court's decisions in *United States* v. *Ludey, supra,* and *Detroit Edison Co.* v. *Commissioner, supra.* We also rely upon the

decisions of the Fifth Circuit in the *Massey* case and of the Sixth Circuit in *Cohn v. United States*, 259 F. 2d 371,[12] [illegible] of which were decided under the provisions of the 1939 Code.

So far as the administrative practice is concerned, taxpayer's statement flies in the face of the fact that the Regulations, over a period of 35 years, defined useful life in terms of the period of usefulness of the asset in the taxpayer's business. For a full discussion of this history, see the Government's brief in *Evans*, pp. 19–22.

C. UNDER THE 1954 CODE, THE TERM "USEFUL LIFE" CONTINUES TO MEAN THE PERIOD DURING WHICH AN ASSET IS USEFUL TO THE TAXPAYER

As has been pointed out in the Government's brief in *Evans* (pp. 25–26), the term "useful life" was in-

[12] The Sixth Circuit stated in *Cohn* (259 F. 2d at 377):

* * * A reasonable allowance for depreciation of property used in the production of income may be deducted from gross income. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property. Useful life is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. * * * Since it frequently happens that the property may still have some value when it has completed its usefulness to the business, which will be realized by the taxpayer by its sale at the end of its useful life, it is necessary that this salvage value be deducted from the cost in order to find the net amount which is to be amortized over the years the property is to be used in the business.

corporated into the statute by Congress for the first time in the 1954 Code, Section 167(c). In incorporating this term, Congress made it abundantly clear that it was not changing the concept that useful life means the period during which an asset is useful to the taxpayer in his business. The House Committee took pains to point out that depreciation is a method by which the capital invested in an asset is recovered tax-free over the years "it is used in a business" and that this annual deduction is computed by spreading the cost of the property over its estimated useful life.[13] H. Rep. No. 1337, 83d Cong., 2d Sess., p. 22 (3. U.S.C. Cong. and Adm. News (1954), 4017, 4046–4047). It stated further (H. Rep. No. 1337, *supra*, p. 25 (3 U.S.C. Cong. & Adm. News (1954), 4017, 4049)) that "The changes made by your committee's bill merely affect the timing and not the ultimate amount of depreciation deductions with respect to a property."

In explaining the newly adopted declining balance method of depreciation, the House Committee also demonstrated its intention that depreciation be measured by true economic usefulness and realistic estimates of useful life, rather than by artificial concepts of useful life. The Committee stated (H. Rep. No. 1337, *supra*, p. 23 (3 U.S.C. Cong. & Adm. News (1954), 4017, 4048)):

> In the formation of its liberalized depreciation policy your committee relies heavily upon the use of an improved declining-balance method. This method concentrates deductions in the

[13] The full quotation from the Committee Report appears in our *Evans* brief (p. 25).

> early years of service and results in a timing of allowances more in accord with the actual pattern of economic usefulness.

The report of the Senate Committee is to the same effect. S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 25–26 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4656).[14]

Taxpayer attempts to buttress its case by reference to isolated words used in the Committee Reports or by members of Congress in discussing the bill which became the 1954 Code. It refers (Br. 57–58) to expressions such as "short-lived properties," "the life of a property," "the estimated useful life of the property". But such phrases, in the absence of explanation, do not provide an answer to the question whether "useful" means useful in the abstract or useful in the taxpayer's business. The answer is to be found in the statement of the Committee which recommended the legislation—in its explanation that depreciation allowances are made to enable a taxpayer to recover the cost of an asset over the years the property is used "in a business".

Taxpayer's quotations from Senator Bennett and Undersecretary Folsom (Br. 59–60) are beside the point, since they merely refer, in the case of the for-

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[14] Taxpayer's assertion (Br. 53–54) that Section 167(b) indicates a different concept of useful life grasps at straws. It refers to the fact that in paragraph (4) of that subsection, Congress used the words "the taxpayer's use" of the property as well as the words "useful life". An attempt to change recognized concepts of depreciation can hardly be inferred from the use of what may be described at best as inconclusive phraseology. Moreover, the words to which taxpayer refers do not, when the paragraph is read in its entirety, lend any support to the interpretation which taxpayer seeks to place upon them.

mer, to the profit measured by sale price less depreciated cost, and, in the case of the latter, to accelerated methods of depreciation; neither refers to any definition of useful life. Moreover, Senator Bennett's statement actually disproves the very contention which it is used to support. If an asset is held for a period less than its physical business life, it can never be depreciated "all the way", to use Senator Bennett's expression, if useful life means the physical business life and not the period during which it is held by the taxpayer. In such a case, depreciation could be taken only in the approximate proportion which the holding period bears to the entire physical business life and complete depreciation could never be effected.[15]

Taxpayer stresses the existence of a legislative purpose to stimulate capital investment by liberalizing the methods of computing depreciation. (Br. 63-64.) That this was the purpose behind the provision authorizing use of accelerated methods of depreciation is, of course, clear. But the House Committee was careful to state, as pointed out above (pp. 33–34), that this liberalization was to be effected by concentrating deductions in the early years and by timing allowances "in accord with the actual pattern of economic use-

[15] Taxpayer also refers to a floor discussion among various Senators as pointing to the conclusion that useful life means physical business life. (Br. 61, 115–119.) A reading of this discussion demonstrates, however, that the Senators concerned were referring to average rates of depreciation for farm equipment, and that, as Senator Daniel stated, it was possible to depreciate such equipment over shorter periods. It is apparent that Senator Douglas' statements are colored by the fact that he was sponsoring an amendment providing for depreciation of farm equipment over a fixed period of four years.

fulness." This statement demonstrates that no change in the total amount of depreciation deductions allowable was contemplated, a conclusion confirmed by the committee's further statement that the changes made merely affect the timing, not the ultimate amount, of depreciation deductions allowable. H. Rep. No. 1337, *supra*, p. 25. Moreover, if depreciation is to be measured by true economic usefulness, as the Committee stated, this objective can be achieved only by adopting the views which the Government urges. If the taxpayer were permitted to depreciate its automobiles on the basis of a useful life of four years when it holds such automobiles only for a period slightly in excess of two years, depreciation would be taken not "in accord with the actual pattern of economic usefulness" but on the basis of a wholly fictitious concept of usefulness. The assets in question are obviously economically useful to the taxpayer only during the period in which it holds them, not for an additional two year period when they are in the possession of some unrelated taxpayer.

D. TAXPAYER'S CONCEPT OF "USEFUL LIFE" WOULD MAKE THE DEPRECIATION DEDUCTION A DEVICE FOR TAX AVOIDANCE

It has been pointed out in our brief in *Evans* (pp. 27-29) that the depreciation deductions sought by taxpayers in the three pending cases would become a method not for the recovery of cost, but for the realization of capital gains.[16] This is strikingly il-

[16] Taxpayer argues at some length (Br. 72-74) that the Commissioner has unsuccessfully proposed legislation which would deny capital gains treatment to business assets. This is so. It has no bearing, however, on the question whether taxpayer is

lustrated by the instant case in which taxpayer seeks to use an accelerated method of depreciation and thus to increase its depreciation deductions during the limited period in which it holds the assets.

Under the declining balance method, a taxpayer holding property which will be useful to him for a period of four years may take a depreciation deduction of 50% (double the straight line rate of 25%) of his investment in the first year and 50% of the remaining balance of undepreciated cost in each of the three succeeding years. Under this method a taxpayer may depreciate his asset to the extent of 75% in two years (considerations of salvage value aside). Thus, in the case of an asset costing $2,000 which has a useful life of four years, a taxpayer will be entitled to deduct $1,000 in the first year and $500 in the second—a total depreciation deduction of $1,500, or 75% of his basis.

If a taxpayer, as in the instant case, is in the car rental business and can reasonably expect to use his automobiles for a period of approximately two years, but is permitted nevertheless to claim accelerated depreciation on the basis of a four-year useful life merely because the cars are usable for business purposes for a period of four years, the advantages to the taxpayer are obvious. At the end of two years he has depreciated his automobiles down to an amount equivalent to 25% of their original cost, taking the deductions as an offset against income taxable at a 52% rate. If he can then sell them at a relatively

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claiming depreciation deductions in inflated amounts as a means of enhancing or creating capital gains which it would not otherwise realize.

high price, which he may reasonably expect to do since they are still highly usable,[17] he realizes a considerable profit which is taxable as a capital gain at a maximum rate of 25%. This, as the District Court noted (R. 119), results in a "tax avoidance scheme of some magnitude." [18]

II

UNDER THE DECLINING BALANCE METHOD OF DEPRECIATION AN ASSET MAY NOT BE DEPRECIATED BELOW A REASONABLE SALVAGE VALUE

A. Concededly, taxpayer's trucks had a useful life to the taxpayer of more than three years and might be depreciated under the declining balance method. The issue with respect to these assets is whether they may be depreciated below a reasonable salvage value.

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[17] During the taxable years in question, taxpayer resold its cars at an average figure of $800 (R. 13–18.)

[18] The District Court illustrated this as follows (R. 119):

"Automobile #239—Chevrolet #01054—Held and used by taxpayer for 14 months and then sold:

"Cost		$2,048.00
"Depreciation (50% of Declining Balance):		
"1st year	$1,024.00	
"2d year (held 2 months)	85.33	
		1,109.33
"Basis at time of sale (1/15/57)		938.67
"Selling price		1,600.00
"Long term capital gain		661.33
"Tax on gain (25%)		164.33
"Net gain after taxes		496.00
"Recovery through depreciation		1,109.33
"Recovery of remaining basis through sale		938.67
"Total recovery		2,544.00"

The above example was taken from taxpayer's own records. Note that it permits the taxpayer a recovery of almost $500 more than the cost of the car.

The same question would be reached, in relation to taxpayer's automobiles, only in the event that this Court should disagree with the Commissioner on the issue discussed under Point I.

Section 1.167(a)-1(a) of the Treasury Regulations (Appendix, *infra*, p. 59) provides that "An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation."[10] Section 1.167(b)-2(a) (Appendix, *infra*, pp. 62-63), which is specifically devoted to the declining balance method, likewise provides:

> * * * While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value.

These Regulations are authorized by the language of Section 167(a) of the 1954 Code permitting a "reasonable allowance" for depreciation and by Section 167(b) of the Code which provides that the term "reasonable allowance" shall include an allowance "computed in accordance with regulations prescribed by the Secretary or his delegate."

As pointed out in the Government's brief in *Evans* and noted in the preceding portions of this brief, salvage value is an essential component of tax depreciation. Depreciation, this Court has stated, may be taken in an amount which, together with salvage value, will result in the recovery of the cost or other basis of the property by a taxpayer. *United States*

[10] The same provisions may be found in Section 1.167(a)-1 (c) of the Regulations (Appendix, *infra*, pp. 60-61) dealing with salvage value.

v. *Ludey,* 274 U.S. 295; *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98. See also *Cohn* v. *United States,* 259 F. 2d 371 (C.A. 6th).

In computing depreciation under the straight line method—the method most frequently used prior to the advent of the 1954 Code—salvage value is taken into account by subtracting the estimated salvage value from the cost or other basis of the asset; the appropriate rate of depreciation is then applied to the remainder. Section 1.167(b)(1)(a) of the Treasury Regulations (Appendix, *infra,* p. 62). *Cohn* v. *United States, supra; Goldberg* v. *Commissioner,* 239 F. 2d 316 (C.A. 5th); *W. H. Norris Lumber Co.* v. *Commissioner,* decided October 12, 1948 (1948 P-H T.C. Memorandum Decisions, par. 48,204); *Bolta Co.* v. *Commissioner,* decided November 28, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,360). As the Sixth Circuit recently stated in *Cohn* v. *United States, supra* (259 F. 2d at 377):

> * * * Since it frequently happens that the property may still have some value when it has completed its usefulness to the business, which will be realized by the taxpayer by its sale at the end of its useful life, it is necessary that this salvage value be deducted from the cost in order to find the net amount which is to be amortized over the years the property is to be used in the business.

As the decisions also make clear (*e.g., Evans, Massey* and *Cohn*), salvage value, for purposes of depreciation, means more than "junk value."

Taxpayer asserts, however (Br. 80–93), that salvage value is inherent in the computation of depreciation under the declining balance method and hence need not

be taken into account. This view was accepted by the District Court (R. 127–128) but rejected by the Court of Appeals. (R. 138–139.)

It is true, to be sure, that the Regulations do not require a taxpayer to deduct salvage value from cost before computing depreciation under the declining balance method. They do provide, however, that once the asset has been depreciated down to an amount which corresponds to the estimated salvage value, no further depreciation is allowable. It is this limitation set out by the Regulations which is in issue.

In support of its position that salvage value is "built in" or inherent in the declining balance method, taxpayer relies upon language used by the Senate and House Committees in their Reports on the 1954 Code. In discussing the declining balance method, the Senate Report (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 201 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4836)) states:[20]

> * * * The salvage value is not deducted from the basis prior to applying the rate, since under this method at the expiration of useful life there remains an undepreciated balance which represents salvage value. * * *

This language, we submit, does not require a result contrary to that set forth in the Regulations. The first part of the statement is, of course, consistent with the Regulations adopted by the Commissioner since, under those Regulations, salvage value "is not deducted from the basis prior to applying the rate."

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[20] The same statement may be found in the Report of the House Committee (H. Rep. No. 1337, 83d Cong., 2d Sess., p. A48 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4185)).

The Regulations merely impose a cut-off point measured by salvage value (estimated at the time of acquisition or appropriately adjusted thereafter) beyond which no further depreciation may be taken. This carries out the fundamental principle previously discussed: that depreciation should be taken in an amount which, together with salvage value, will effectuate the recovery of cost over the period of useful life.

The remainder of the quoted statement—the portion which declares that "at the expiration of useful life there remains an undepreciated balance which represents salvage value"—is a recognition of the fact that when the declining balance method is used there is always some theoretical salvage value left.[21] But it does not require the conclusion that reasonable or predictable salvage value may not exceed this figure; nor does it override the basic statutory requirement that the allowance for depreciation be reasonable.

Under the declining balance method, as noted above, one applies a fraction or percentage to the cost (or other basis) of the asset. The next year, one applies the same rate to the undepreciated balance. The process is continued, from year to year, over the period of useful life. Since the method involves an infinite progression—the application of the fixed per-

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[21] The Report of the Senate Committee recognizes that this is only a theoretical salvage value, and it recommends that a taxpayer be authorized to switch from the declining balance method to the straight line method to deal with the situation where the theoretical value proves high in relation to the actual salvage value. S. Rep. No. 1622, *supra*, p. 27. This proposal was adopted. Section 167(e).

centage to a constantly declining amount which can never reach zero—there is always some undepreciated balance remaining. What is undepreciated is in theory a remaining or a salvage value. So much is common ground. It does not follow, however, that if it is predictable that at the termination of the taxpayer's holding period the actual salvage value will be higher than the theoretical one, taxpayer may ignore the predictable or known factors and depreciate the asset beyond the point where he has recovered his costs.

An illustration may be useful. Let us assume that a taxpayer has a truck which cost $3,000, has a useful life of four years and a predictable salvage value, at the end of such period, of $300.[22] If a taxpayer were to depreciate this truck under the straight line method, he would first deduct the salvage value of $300 from cost, leaving a balance of $2,700 to be depreciated in four equal annual installments. At the end of the four year period, he will have received depreciation totalling $2,700 and will realize the balance of his cost, $300, upon sale of the truck; his cost is thus entirely recovered.

If we apply the declining balance method to this same set of facts, and do not take into account the predictable salvage value, what is the result? Under this method, the taxpayer does not deduct salvage value from cost at the outset and is permitted to deduct double the straight line rate, or 50%, of the undepre-

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[22] This is a very conservative amount, as is illustrated by the fact that the tax returns herein show that the average resale price of taxpayer's trucks was approximately $500. (R. 13–18.)

ciated balance each year. In the first year, he therefore takes depreciation in the amount of $1,500; in the second year, he deducts 50% of the remainder, or $750; in the third year, $375; and in the fourth year, $187.50. His total recovery through depreciation over the four-year period thus amounts to $2,812.50, leaving an unrecovered cost or depreciated basis of $187.50. If salvage is not to be considered under this method, the taxpayer, upon sale of the asset for its $300 salvage value, realizes a profit of $112.50 taxable at capital gains rates. By the same token, he has been allowed excessive depreciation deductible at the 52% ordinary income rates.

The undepreciated balance may, of course, represent an amount considerably less than full salvage value.[23] As the illustration shows, acceptance of taxpayer's position means that the total amount of depreciation allowable under the declining balance method exceeds that allowable under the straight line method. Under the former, as we have seen, the de-

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[23] We have dealt with straight line and declining balance depreciation. A third method of depreciation expressly authorized by the statute is the sum of the years-digits method (Section 167(b)(3), Appendix *infra*, p. 56). As explained on the same page of the Senate Committee Report (S. Rep. No. 1622, *supra*, p. 201) on which the statement quoted on page 41, *supra*, appears: "Under this method the annual allowance is computed by applying a changing fraction to the taxpayer's cost of the property *reduced by the estimated salvage value.*" (Italics supplied.) It seems unlikely to suppose with taxpayer that the Committee intended in the case of the declining balance method alone that an asset should be depreciated below reasonable salvage value.

preciation deductions total \$2,812.50, whereas, under the latter, the total depreciation deduction is \$2,700. Such a result, however, is directly contrary to the legislative intent expressed by the House Committee in reporting the bill. The Committee stated (H. Rep. No. 1337, *supra*, p. 25 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4049)):

> * * * The changes made by your committee's bill merely affect the timing and not the ultimate amount of depreciation deductions with respect to a property.

It was precisely because taxpayer's position would lead to an increase in "the ultimate amount of depreciation deductions" that the Court of Appeals rejected it. (R. 138-139.)[24]

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[24] Taxpayer points to a statement in the Senate Committee Report (S. Rep. No. 1622, *supra*, p. 29) that declining balance depreciation is being limited to assets with a useful life of three years or more because, in the case of an asset with a two-year useful life, this method would "be equivalent to expensing the cost in the year of acquisition." The full cost could not be "expensed," taxpayer argues, unless salvage value is ignored; hence, that is what the Committee contemplated. The point that the Committee was making, however, was that it wished to prevent unrealistic deductions and extremely fast writeoffs. In the case of a two-year asset, use of the declining balance method would mean that all depreciation, whether limited by salvage value or not, would be taken in a single year inasmuch as the method contemplates a rate double the straight line rate (which is 50 percent for a two-year asset). Since the Committee was addressing itself to the matter of undue acceleration of depreciation, its statement provides scant affirmative evidence that it contemplated any abandonment of the settled principle that salvage value limits the total amount of available depreciation. As noted in the text, the House Committee expressly stated that there would be no such change.

In summary, the Regulations in question merely invoke the settled principle that depreciation is a method for the recovery of cost and nothing more. Assuredly, they are consistent with the statute which permits a "reasonable allowance" to be "computed in accordance with regulations prescribed by the Secretary." (Section 167 (a), (b).) And in light of the Committee's declaration that authorization of the declining balance method changes the timing but not the ultimate amount recoverable by depreciation, there is no warrant for suggesting that they conflict with Congress' underlying purpose. Accordingly, they must be sustained. *Brewster* v. *Gage*, 280 U.S. 328; *Maryland Casualty Co.* v. *United States*, 251 U.S. 342.

B. There remains for consideration several peripheral arguments which taxpayer offers in support of its thesis that actual salvage value may be ignored when the declining balance method is used.

(1) Despite formal Treasury Regulations providing, in relation to the declining balance method, that "in no event shall an asset (or an account) be depreciated below a reasonable salvage value" (see *supra*, p. 39), taxpayer suggests that the Court should be persuaded by what is alleged to be an inconsistent footnote appearing on a form which the Treasury published.[25]

This form, known as Form 2106, is a worksheet for employees claiming business expenses, including depreciation on automobiles. Items 40 through 45 are directed to computation of the basis for depreciation

[25] This form, as revised in October 1956, is reproduced in taxpayer's brief facing page 88.

of a taxpayer's car. Thus, these items read: "(40) Purchase price of present car; (41) Last estimated salvage value[1]; (42) Difference between items 40 and 41; (43) Item 42 times percent shown in Item 29; (44) Less gain or plus (*loss*) on trade-in of previous vehicle (*Item 39*); (45) Basis of present car for computing depreciation for taxable year." Taxpayer refers to the footnote to item 41, which reads: "Salvage value is the estimated resale or trade-in value of the vehicle, determined at the time of purchase. If declining balance method of depreciation is used, disregard salvage value in computing depreciation." But this footnote actually represents nothing inconsistent with the Commissioner's position here. As already stated (and as the Regulations provide), salvage value, though deducted at the outset in determining the basis for straight line depreciation, is, in the case of the declining balance method, disregarded (to use the phraseology of the form) or "not taken into account" (the language of the Regulations, Section 1.167(b)(2)(a), Appendix, *infra*, p. 62) in determining the annual allowance. The Regulations then provide that in no event shall an asset be depreciated below a reasonable salvage value. Thus, as the form indicates, salvage would not properly be deducted under item 41 from item 40 in order to compute in item 45 "[b]asis of present car for computing depreciation for taxable year."

The footnote does not mean that salvage value is to be disregarded in *all* respects and that the asset may be depreciated below a reasonable salvage value. It is not to be assumed that the Commissioner would

provide in three separate sections of the Regulations that depreciation may not be taken below a reasonable salvage value and yet promulgate a form designed to authorize a contrary result. If it be granted that the form might have been better drafted,[26] we may nonetheless rely on the proposition that formal Treasury Regulations have considerably more standing than a worksheet.

(2) Taxpayer quotes (Br. 82–83) a recommendation made to Congress in 1954 by the American Institute of Accountants as supporting its position. But that recommendation merely states that, by reason of the elimination of the requirement that salvage value be deducted from cost in computing declining balance depreciation, the *initial* deduction under this method may be more than twice that allowed under the straight line method. This is obviously true, as has been demonstrated in the illustration discussed at pp. 43–44, *supra*. Under the straight line method, in that illustration, the taxpayer would be entitled, in the first year, to a deduction of 25% of $2,700 or $675, whereas under the declining balance method the initial deduction is $1,500. The statement does not even purport to discuss the question whether salvage value constitutes a limitation upon the total depreciation allowable. We refer, in contrast, to the views of a former Tax Legislative Counsel of the Treasury Department, who states that to disregard salvage value in declining balance depreciation would represent a fundamental departure from recognized concepts, and

[26] The form was revised in November 1958, and the footnote in question no longer appears.

that much more than ambiguous language in a Congressional Committee Report would be required to demonstrate that such fundamental changes were intended. Kirby, *Accelerated Depreciation and the Treasury Regulations*, 54 Northwestern L. Rev. 434, 452 (September–October, 1959).

(3) Taxpayer suggests (Br. 88) that it is of no moment that an asset may be depreciated below salvage value and then sold at an amount in excess of depreciated value, because it must pay tax on the profits in any event. This argument not only ignores the express Congressional intent that accelerated methods of depreciation should not be permitted to increase the total amount of depreciation deductions allowable, but also ignores the fact that taxpayer's depreciation deductions are taken at the rate of 52%, while the tax on its profit is at the 25% capital gains rate. Similarly, taxpayer is in error when it asserts (Br. 89) that the profit results not from depreciation, but from the state of the market. If taxpayer is permitted regularly to depreciate its assets below predictable salvage value, the profit, to borrow taxpayer's term, is virtually "built in" or guaranteed, for the salvage value, if properly estimated, should represent a reasonably accurate estimate of market price. The resulting profit, therefore, flows, at least in substantial part, from the failure to recognize the limitation imposed by salvage value.

Unless salvage value is applied as a limitation upon declining balance depreciation, as provided in the Regulations, taxpayer is enabled to use that method of depreciation to create profits taxable at capital gains

rates and excessive depreciation deductible at ordinary income rates. Such a use of accelerated depreciation perverts the depreciation deduction and makes it a means of tax avoidance rather than a means for the recovery of cost.[27] It does not merely affect the timing; it increases the ultimate amount of depreciation with respect to a property. (R. 138–139.)

III

THE REGULATIONS ISSUED UNDER THE 1954 CODE ARE APPLICABLE TO THE TAXABLE YEARS HERE INVOLVED

The Regulations concerning depreciation under the 1954 Code were promulgated on June 11, 1956. T.D. 6182, 1956–1 Cum. Bull. 98. The taxable years in question are the fiscal years ending March 31, 1954, March 31, 1955, and March 31, 1956. The District Court, which was of the view that the depreciation provisions of the 1954 Code, and the Regulations issued thereunder, represented a change from existing law, concluded that the Regulations could not be applied retroactively to taxable years ending before their issuance. (R. 129.) The Court of Appeals found it unnecessary to rule upon the point, since it held that

[27] In *Cohn* v. *United States*, 259 F. 2d 371, the Sixth Circuit was alert to prevent a comparable abuse. It required that the taxpayers, who had reasonable notice that their assets had relatively high salvage value, adjust their depreciation deductions in the last years of useful life to take account of that factor. Taxpayers in that case had not deducted any salvage value in the first instance (though they were operating under the straight line method) and the court appropriately held that no further depreciation deductions were allowable after the assets had been depreciated down to reasonable salvage value.

neither the 1954 Code nor the Regulations represented a change from prior law. (R. 138.)[28]

The Government, of course, does not agree that either the 1954 Code or the Regulations issued thereunder represented any change from prior law. As we have previously noted, both the statutory provisions and the Regulations embody the traditional concept of depreciation, *i.e.*, the recovery of the cost of the investment in a business asset over the period during which it is useful to the taxpayer in the business. This concept has never been changed by any statute, regulation, ruling or Treasury Decision. The provisions of the 1954 Code and the subsequent Regulations merely represent a more explicit expression of this basic concept. Graves, *Depreciation Problems, Journal of Accountancy* (October 1956), p. 43.

On the hypothesis, however, that the 1954 Code, and the subsequent Regulations, did represent a change from prior law, we shall argue (1) that the Regulations were not, in fact, retroactively applied to this taxpayer and (2) that, even if they were, such application was proper.

In its tax returns for each of the years here involved, taxpayer reported depreciation under the

[28] In referring to the Regulations under this point, we include only the Regulations with respect to the meaning of the term "useful life". No issue as to retroactive application of the Regulations is presented with respect to the question of salvage value, for the Commissioner's Regulations on that subject have always referred to salvage value as a limitation upon depreciation deductions. See the Regulations cited on pages 20–21 of the Government's brief in *Evans*.

straight line method. (R. 111.) It did not make an election to claim depreciation deductions under the declining balance method until its claims for refund were filed in September, 1956 (R. 77–93, 96–97)—three months *after* the Regulations in question had been promulgated. Taxpayer thus made its election to claim declining balance depreciation with full knowledge of the provisions of the 1954 Code, approved some two years earlier, as well as the provisions of the Regulations issued three months previously. In fact, taxpayer's election was made under the provisions of Section 1.167(c)–1(c) of the Regulations. (Appendix, *infra*, p. 63.) Taxpayer, therefore, did not act in reliance upon any statute, regulation or ruling which would have led it to believe that it was entitled to use the declining balance method of depreciation for its automobiles on the basis of their entire physical business life. On the contrary, taxpayer had been unequivocally notified in the Regulations that it was not entitled to claim depreciation in the manner specified in its claim for refund. Its purpose was to challenge the validity of those Regulations.[29] Thus, this case involves a prospective, not a retrospective, application of the Regulations. Moreover, taxpayer was claiming a benefit not previously available to it, *i.e.*, declining balance depreciation at double the straight line rates. This benefit was claimed after the Regulations had been issued and pursuant to them. Taxpayer may not elect to claim the benefits provided by the Regulations

[29] The question of retroactive application of the Regulations was raised, *sua sponte*, by the District Court.

and at the same time refuse to accept the limitations which they impose. Cf. *Callanan Road Co.* v. *United States,* 345 U.S. 507, 513.

In any event, Section 7805(b) of the 1954 Code (Appendix, *infra,* p. 59) permits retroactive application of Regulations and rulings issued by the Secretary of the Treasury or by his delegate, the Commissioner. This power has been sustained under corresponding provisions of prior Revenue Acts. *Automobile Club* v. *Commissioner,* 353 U.S. 180; *Helvering* v. *Reynolds,* 313 U.S. 428; *Manhattan Co.* v. *Commissioner,* 297 U.S. 129. In *Helvering* v. *Reynolds, supra,* this Court upheld a regulation issued under the Revenue Act applicable to the taxable year in controversy, notwithstanding the fact that the Regulations changed the prior interpretation of the law under earlier Acts. Not only did this Court state (p. 432) that the prior construction "gives way before changes in the prior rule or practice through exercise by the administrative agency of its continuing rule-making power"; it held further (p. 433):

> The regulation here in question was promulgated under the very Act which determines respondent's liability. The fact that the regulation was not promulgated until after the transactions in question had been consummated is immaterial.

Taxpayer relies (Br. 94–96) upon cases such as *Helvering* v. *Griffiths,* 318 U.S. 371, and *Helvering* v. *Reynolds Co.,* 306 U.S. 110. In those cases, however, a significantly different situation was presented. There, it appeared that the transaction in question oc-

curred at a time when the regulation negatived tax liability, that the regulation had been followed by several reenactments of the statute, and that it was not amended to provide for liability until some years after the transaction occurred. Here, there is no question of legislative reenactment in the face of a prior contrary interpretation; taxpayer's argument on this point assumes that the Regulations were authorized by the 1954 Code. Unlike the cases relied upon by the taxpayer, the Regulations here in question, as in *Helvering* v. *Reynolds, supra,* were promulgated "under the very Act which determines" liability, and the fact that they were not issued until after the transactions in controversy had occurred "is immaterial." Retrospective application would accordingly be proper, at least in the absence of a showing—and none has been attempted—of an abuse of discretion. *Automobile Club* v. *Commissioner, supra.*

In addition, the change from prior law, if any, was made by the 1954 Code itself and not by the Regulations; the latter are merely declaratory of that law. On this basis as well, we submit that no problem of retroactivity is presented.

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted.

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FEBRUARY 1960.

APPENDIX

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of Certain Methods and Rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed

under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) *Limitations on Use of Certain Methods and Rates.*—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

* * * * *

(f) *Basis for Depreciation.*—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

* * * * *

(26 U.S.C., 1958 ed., Sec. 167.)

* * * * *

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gain and losses), adjusted as provided in section 1016.

(26 U.S.C., 1958 ed., Sec. 1011.)

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapter C (relating to corporate distributions and adjustments), K relating to partners and partnerships), and P

(relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

(26 U.S.C. 1958 ed., Sec. 1012.)

* * * * *

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws.

* * * * *

(26 U.S.C. 1958 ed., Sec. 1016.)

* * * * *

SEC. 7805. RULES AND REGULATIONS.

(a) *Authorization.*—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) *Retroactivity of Regulations or Rulings.*—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

* * * * *

(26 U.S.C. 1958 ed., Sec. 7805.)

Treasury Regulations on Income Taxes (1954 Code):

SEC. 1.167(a)–1. *Depreciation in general.*—(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and §1.167(f)–1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments.

Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation . However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by

the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)–2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)–1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

* * * * *

SEC. 1.167(b)–0. *Methods of computing depreciation.*—(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered

cost or other basis less salvage during the remaining useful life of the property. * * *

* * * * *

SEC. 1.167(b)-1. *Straight line method.*—(a) *Application of method.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

* * * * *

SEC. 1.167(b)-2. *Declining balance method.*—(a) *Application of method.* Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(f), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(b)(2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below

a reasonable salvage value. See section 167(c) and § 1.167(c)-1 for restrictions on the use of the declining balance method.

* * * * *

SEC. 1.167(c)-1. *Limitations on methods of computing depreciation under Section 167(b) (2), (3), and (4).*— * * *

* * * * *

(c) *Election to use methods*—Subject to the limitations set forth in paragraph (a) [of this section], the methods of computing the allowance for depreciation specified in section 167 (b) (2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) [of this section], he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any property shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167(b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

U. S. GOVERNMENT PRINTING OFFICE: 1960

In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 283

THE HERTZ CORPORATION, a corporation (**SUCCESSOR BY MERGER TO J. FRANK CONNOR, INC.**, a corporation),
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 283

THE HERTZ CORPORATION, a corporation (SUCCESSOR BY MERGER TO J. FRANK CONNOR, INC., a corporation),
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER.

ARGUMENT.

The argument advanced in the Government's brief consists of generalities addressed to what the Government thinks the law should be rather than what it is and how it has actually been administered and construed. Thus, the Government does not focus on the statutory standards for determining depreciation—"exhaustion, wear and tear"—which are physical facts, or on the forty years of precedent which relate them to the physical life of a property.

Instead, the Government's position, in essence, comes to this—as a policy objective, the depreciation allowance should be tailored to maximize the revenue by eliminating or substantially restricting capital gain treatment of the sale of depreciable business property. The Government would have the Court sanction this policy under the guise that it constitutes an exercise of interpretative and rule making authority. The Government's objective can be obtained only by adoption of the Government's present concepts of useful life as being the holding period of the particular taxpayer and of salvage value as being market value at the end of that holding period.

The difficulty with this approach is twofold: first, the Government is here seeking court approval of a profound policy determination which is properly for Congress, not for the administrative or judicial process; and, second, the Government, lacking Congressional sanction, is without authority to amend, indeed to reverse, what is clearly well settled law.

The impropriety of this assumption of responsibility by the Government is emphasized by the fact that, if this problem is viewed solely as a policy matter, all the relevant factors—economic, fiscal, statistical and others—are not before this Court as they would be before Congress. For instance, to offer the simplest example, can one resolve the question whether it is appropriate in an inflationary era to *limit* the measure of depreciation by taking market value into account for purposes of determining salvage value, without also at least considering the extent to which market

value (in the form of replacement cost) should be taken into account in order to *increase* this measure? Merely to put this question compels a negative answer. Nevertheless, the Government seeks the *imprimatur* of this Court on its attempted administrative policy-making in one of the most important areas within the larger problem of the role of federal income taxation in an expanding an. (thus far) inflationary economy. Such policy-making would constitute a clear usurpation of the legislative function. And the Government blandly seeks such approval after it has repeatetlly sought and failed to obtain a statutory directive to permit it to do what it is now asking this Court to approve.

The Government's present effort to minimize capital gains treatment through constriction of the depreciation deduction ignores the true purpose of that deduction—which is to recognize physical erosion caused by "exhaustion, wear and tear"; it introduces extraneous concepts of holding periods, market values and capital gains into the depreciation formula; it flies in the face of the Government's own long-standing interpretation to the contrary that useful life for depreciation purposes means physical life, and salvage value means the residual value remaining at the end of physical life; and it subverts the Congressional policy expressed in the depreciation allowance and capital gains provisions of the Internal Revenue Code. For these and other reasons, elaborated in our opening brief and in this reply brief, the Government's argument should be rejected.

(1) The Government has completely failed to show that its current view of "useful life" was the law under the 1939 Code.

The Government—editing our brief—states at page 31 of its brief that "Taxpayer erroneously states (Br. 47) that the Government does not cite, in support of its position, any cases or rulings decided or published before the enactment of the 1954 Code." What we actually said at page 47 was:

> ". . . the Government has not offered a single citation of any case or ruling decided or published before the enactment of Section 167 *in which it even contended (much less established) that useful life meant a taxpayer's holding period.*" (Emphasis added.)

That challenge remains unanswered, even after submission of the Government's latest brief in the case at bar and its Brief for the Petitioner in *Evans*, No. 143, this Term.

By way of irrelevant rejoinder, the Government offers the generalities of *United States* v. *Ludey*, 274 U.S. 295 (1927), and *Detroit Edison Co.* v. *Commissioner of Internal Revenue*, 319 U.S. 98 (1943). (Obviously, the Government's reliance on *Massey*, 264 F. 2d 552 (5th Cir. 1959), certiorari granted October 12, 1959, No. 141, this Term, and *Cohn* v. *United States*, 259 F. 2d 371 (6th Cir. 1958) does not answer our challenge, for both of those cases were decided well *after* the enactment of the 1954 Code. They are recent after-the-fact attempts to establish a purported line of authority.)

The Government's vague assurances that its new, specially-tailored useful life and salvage value formulas "merely represent a more explicit expression of [the Government's] basic concept"[1] (Brief for the United States, page 51) are merely a latter-day effort at diverting the Court's attention from the Government's failure to find any authority for its position that those new formulas always represented the law. In the light of this failure, for the Government to claim—as it does—that in the 40-

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[1] The Government cites for this statement Graves, "Depreciation Problems," *The Journal of Accountancy* 43 (October, 1956).

It is striking that Mr. Graves actually appears to take a position directly contrary to that ascribed to him by the Government. At the very page (43) cited by the Government, Mr. Graves points out:

> "In its attempt to prevent abuse of the accelerated-depreciation methods, the Treasury limited the concept of a reasonable depreciation allowance by an *abrupt change* in its approach to the determination of useful life and salvage value.
>
> "In the past it was the general practice to consider useful life *as the period during which it was normally expected that an asset would be useful if it were used until its value was substantially exhausted. In many instances salvage value was disregarded.* If recognized at all, it usually was estimated at a nominal amount closely related to scrap value." (Emphasis added.)

Moreover, as stated at page 86, footnote 36 of our opening brief, the very same article points out (page 46) that the mechanics of the declining balance method

> ". . . result in an ultimate salvage value because the depreciation allowances are not sufficient to provide for complete recovery of basis at the end of the estimated life of an asset. However, the regulations provide that an asset cannot be depreciated below salvage value under any method. This provision is not unreasonable in itself but *there seems to be no authority for it in the Code.*" (Emphasis added.)

year application of the much-litigated depreciation statute (which gives rise to one of the largest single deductions) the Government's present position was really inherent or implicit all along, is to ask this Court to see something that was not there at all.

The fact is that our original statement that when the term "useful life" first appeared in the depreciation statute in 1954, it had come to mean the physical or inherent functional life of depreciable property to taxpayers, lawyers, accountants, the courts *and the Commissioner*—stands unanswered.

(2) The Government's brief fails to explain away the authorities on "useful life" cited in the taxpayer's opening brief.

(a) *Cases.*

[25][2] *Max Kurtz, et al.*, 8 B.T.A. 679 (1927), Acq. VII-1 CB 18.

The Government says, erroneously, that the Board of Tax Appeals, in determining that a useful life of five years was reasonable, relied on evidence that the taxpayer used its trucks for about four years. A review of the Board's findings in that case clearly shows that the Board considered that "evidence" unreliable (8 B.T.A. at 683), and, instead of relying on it, the Board made its own findings discussed at pages 23 and 25 of our opening brief. And the Government fails to refer to, or explain, the allowance

[2] Page number references to the Brief for the United States are indicated in brackets.

of a five-year *useful life* on a *holding period* of two or three years.

[26] *General Securities Co.,* B.T.A. Memo, CCH Dec. 12,500-D(1942), *aff'd,* 137 F. 2d 201 (6th Cir. 1943).

The Government's statement that the taxpayer's president testified to a useful life of three years is, of course, irrelevant, because it does not show why, if the Government's current theory of useful life was the law all along, depreciation was determined on the basis of a three-year life when the automobiles were kept for only one to two years.

[26] *Philber Equipment Corporation* v. *Commissioner of Internal Revenue,* 237 F. 2d 129 (3rd Cir. 1956).

The "close reading" of *Philber* by the Third Circuit below does not stand up under scrutiny. In that case, the period of rental and the taxpayer-lessor's holding period were exactly one year, and, by the Government's new definition, the "useful life" of the leased property would therefore be one year. But the Third Circuit in *Philber* correctly referred to the holding period as "a period substantially less than its useful life."

[27] *Charlie Hillard,* 31 T.C. 961 (1959).

Contrary to the Government's assertion, reference to page 19, footnote 5 of the Commissioner's Brief for the Respondent in the Fifth Circuit appeal of *Hillard* does *not* disclose any statement that depreciation was allowed by the Tax Court on an incorrect theory.

But reference to the Commissioner's Fifth Circuit briefs in *Hillard*, Docket No. 17,915, is revealing:

As to the four-year depreciable life used by the Commissioner on Hillard's cars, the Commissioner's Supplemental Brief for the Respondent (page 3) belatedly argued that the proper formula for depreciation "should have been" the expected period of usefulness in the particular taxpayer's business. (In his Respondent's Brief in Answer in the Tax Court, the Commissioner had made it a point [page 6] to show that "Petitioner sold his cars after a customary holding period of seven months to one year.")

As to the general definition of "useful life," the Commissioner's Brief for the Respondent (page 9) stated, as the first point in his Argument:

> "After Reviewing All the Evidence Before It, the Tax Court Correctly Found that Rental Vehicles Leased by the Taxpayer *for One-Fourth of Their Useful Life and Then Sold* Constituted Property Held 'Primarily for Sale. . . .' " (Emphasis added.)

At pages 18 and 19 of the Brief for the Respondent, the Commissioner said:

> "The Tax Court recognized that when the taxpayer purchased the cars involved it was his intention to use them in the rent-a-car operation (R. 36) but, as the Tax Court also stated (*id.*), 'for a comparatively minor portion of their useful life and then to sell them.' * * * Those statements are amply justified by the evidence."

At page 4 of his Supplemental Brief for the Respondent, the Commissioner attempted this belated explanation:

"Since no issue of depreciation was here present, the Tax Court's statement (R. 36) that the taxpayer intended to use the cars in the rent-a-car operation 'for a comparatively minor portion of their useful life' obviously had reference only to the physical economic life of the cars."

What does appear obvious is that the Commissioner himself repeatedly equated the terms "useful life" and "physical economic life."

(b) *Administrative pronouncements.*

[28] O.D. 845, 4 CB 178.

The Government's gloss on this ruling ignores the point that the ruling is in terms of exhaustion of the *usefulness* of a property, not termination of its *ownership* by a given taxpayer.

[28] Rev. Rul. 108, 1953-1 CB 185, and Rev. Rul. 54-229, 1954-1 CB 124.

Aside from the editing by the Government of these rulings to conform to its current views, the Government incorrectly states that these rulings "were not concerned with problems of depreciation. . . ." Not only were the rulings directly concerned with the very business in which the taxpayer in the case at bar was engaged, but the Commissioner in those rulings took specific notice of the depreciation problem, stating, in Rev. Rul. 108:

"It should be noted, with respect to depreciation, that the treatment of 'leased automobiles' differs from that of 'demonstrators' in that depreciation is allowable on leased cars prior to their conversion to 'prop-

erty held primarily for sale to customers in the ordinary course of business,' whereas no depreciation is allowable on 'demonstrators'."

[29] Bulletin "F."

We do not understand the significance of the Government's repetition of the cautionary statements in Bulletin "F" to which we drew this Court's attention in our opening brief (pages 33-35). In any event, the Government's treatment of Bulletin "F" in the Brief for the United States is clearly far removed from the "fair construction" which the Ninth Circuit was talking about in *Evans*, No. 143, this Term, when it said:

> "While we recognize that Bulletin 'F' does not have the force of law, we do believe that a fair construction of the pertinent provisions of such Bulletin, aided by the practice of the Commissioner, reasonably indicates that *the Commissioner did not consider as a factor in determining depreciation the expected or intended disposal plans of the taxpayer with respect to property used in his trade or business, nor did the Commissioner consider that the useful life of an asset was to be measured by the estimated holding period of such asset by the taxpayer.*" (264 F. 2d at 510; emphasis added.)

(c) *Government briefs.*

[30] *Penn* v. *Commissioner of Internal Revenue*, 199 F. 2d 210 (8th Cir. 1952).

The Government comments:

> "The Commissioner asserted that useful life in that context could not be equated with the life expectancy

of the life tenant. This was obviously correct, inasmuch as the ownership of the building was divided between the life tenant and the remainderman. The life tenant could not be permitted to recover the entire cost of a building of which he was not the sole owner and which could be expected to be useful for business purposes not only for the period of the life tenancy, but for a period beyond such term as well."

But the Government ignores or suppresses the following provision in the depreciation statute, *which has been in every revenue enactment since 1928*[3] and which refutes the Government's attempted explanation of its *Penn* brief:

> "In the case of property held by one person for life with remainder to another person, the deduction shall be computed *as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.*" (Emphasis added.)

Thus the Government's assertion in the Brief for the United States that "The life tenant could not be permitted to recover the entire cost of a building of which he was not the sole owner. . ." appears to be contradicted by a statute which, for 32 years, has directed that the depreciation allowable to a life tenant be computed as if he *were* the sole owner.

Moreover, the Brief for the United States ignores the key point which its own brief in *Penn* (pages 10-11) makes:

> "The basic fallacy in taxpayer's argument lies in her assumption that 'depreciation' has reference to the life of the owner of property, rather than to *the life*

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[3] *E. g.*, Section 23(l), 1939 Code; Section 167(g), 1954 Code.

of the property itself. . . . Taxpayer's argument disregards not only the portion of Section 23(l) which deals specifically with property held by a life tenant, but the *general provision* that depreciation deductions are allowable 'for the exhaustion, wear and tear . . . of property'. *The wear and tear of 'property' has no relation to the life expectancy of its owner. On taxpayer's theory, every owner of a depreciable interest in property would be entitled to deduct annual depreciation at a rate based on the number of years he expects to live and enjoy the income from the property, instead of the number of years the property may be expected to produce income, a result repugnant to the fundamental concepts of depreciation.*" (Emphasis added.)

Just as the wear and tear of property has no relation to the life expectancy of its owner, the wear and tear of property has no relation to the holding period of its owner.

[30] *Highland Hills Swimming Club, Inc.* v. *Wiseman, District Director, and United States of America,* 59-1 U.S.T.C. Para. 9284 (D.C.W.D. Okla. 1958), *aff'd,* 272 F. 2d 176 (10th Cir. 1959)

The Government's comments on our quotations from this brief simply fail to come to grips with the language used in the brief by the Government itself.

[31] *Herbert Shainberg, et al.,* 33 T.C. No. 28 (1959).

The Government's comment again misses the point: In order to sustain the Government's theory that the taxpayers in *Shainberg* should group building equipment into a composite account for each building, it argued, as we pointed out in our opening brief (page 44):

"The *physical life* of the component parts of the buildings is a prime factor to be considered in determining the useful life of these assets. Presumably, unless other factors are present which would reduce the *physical life* of an asset, *there is no reason why the physical life and useful life would not be the same.*" (Emphasis added.)

The foregoing quotation is yet another clear statement by the Government—this time, made in 1959—which contradicts the Government's position in the case at bar and supports this taxpayer.

(3) The Government's attempted inferences from the legislative history of Section 167 of the 1954 Code do not support either its current view of "useful life" or its current theory of a special salvage stop in the declining balance method.

[33][4] The Government cites language from page 22 of the House Report on the alleged meaning of "useful life." But the Government fails to understand the import of the next sentence, which is. "The annual deduction is computed by spreading the cost of the property over its estimated useful life." In other words, the *rate* of recovery of cost, through depreciation deductions, is determined by the "useful life." This is borne out, for example, by *Terminal Realty Corporation*, 32 B.T.A. 623 (1935), cited at page 16 of the Commissioner's Ninth Circuit brief in *Evans*, with specific reference to page 629. We call the Court's

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[4] Page number references to the Brief for the United States are indicated in brackets.

attention to this statement by the Board of Tax Appeals on that page:

> "Deductions for depreciation are allowed for the purpose of restoring the cost of exhausting property over the period of its use from untaxed earnings derived from its use. The annual allowance is made pursuant to some plan for distributing the total cost of the plant over the period of its *usefulness. It is to be 'a reasonable allowance' with relation to the whole life period of the asset and need not be an exact measure of the actual wearing out of the property in the particular year. Under the 'straight line' method it may be assumed that depreciation proceeds at some average rate based upon an estimate of the number of years that the property will probably last.*" (32 B.T.A., at 629; emphasis added.)

The Board's references to "the *whole life period of the asset*," "the *actual wearing out* of the property" and "the number of years that the property will probably *last*" reveal depreciation as a process of physical exhaustion of the asset and useful life as the entire period of the asset's economic usefulness.

[33, 45] The Government also refers to language at page 25 of the House Report to the effect that: "The changes made by your committee's bill merely affect the timing and not the ultimate amount of depreciation deductions with respect to a property." This language does not appear in the Senate Report.

It is to be noted, first, that, as introduced in the House of Representatives, the bill which ultimately became the 1954 Internal Revenue Code (H.R. 8300, 83rd Cong., 2d Sess.) did not restrict use of the new depreciation methods to assets with a useful life of

three years or more. That restriction was put into the bill—and into the finally enacted statute—by the Senate Finance Committee, which pointed out:

> "... in the case of an asset with a 2-year service life, the doubling of the 50-percent straight-line rate would be equivalent to *expensing the cost* in the year of acquisition." (Senate Report, page 29; emphasis added.)

With the bill thus put into its final form in all respects material to this discussion, Senator Millikin, Chairman of the Senate Finance Committee, stated on the floor of the Senate:

> "The total amount of the depreciation cannot exceed, as at present, the actual cost of the property, *so that* the proposed change merely affects the timing and not the total amount of depreciation deductions." (100 Cong. Rec. 8997, June 28, 1954; emphasis added.)

Against the background of the three-year-life restriction (imposed to prevent writing off the total cost of the asset in one year under the double declining balance method), Senator Millikin's statement seems very clearly to have been made as reassurance to the Senate that none of the new methods of depreciation left open the possibility that more than the cost of the property could be recovered.[4a] However

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[4a] The Government's District Court brief confirms this analysis (page 11):

> "The new methods permit more rapid recovery of the cost of an asset in the early years of its life. They were not in any way, however, intended to provide for a recovery greater than cost. *Thus*, in H. Rep. No. 1337, *supra*, it is observed (p. 25):
>
> " 'The changes made by your committee's bill merely affect the *timing* and not the *ultimate amount* of depreciation deductions with respect to a property.' [Emphasis supplied.]"

long the asset might be held and depreciated, the top potential to which depreciation could reach—as in the straight-line method—would be the cost of the property. And if an asset were held for its full useful life, although the application of the double declining balance method would result in greater allowances of depreciation in the earlier years, the overall total of *depreciation deductions*, as under any method of income tax depreciation, could never exceed cost—and thus, only the timing of the deductions would be changed. Neither the statement at page 25 of the House Report nor the explanation by the Chairman of the Senate Finance Committee says, as the Government suggests, that use of the new methods is to produce exactly the same results as the straight-line method.[5]

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[5] Indeed, the Senate Finance Committee, when it added the sum-of-the-years-digits (SYD) method as an approved new method under Section 167(b), noted that there would *not* be an exact equivalency in results:

> "Taxpayers have expressed considerable interest in having the sum-of-the-years' digits method available as an alternative accounting procedure. This would permit them to obtain essentially the same results as the declining balance method without being bound by the automatic 10 to 13 percent salvage value characteristic of the declining balance system." (Senate Report, page 28.)

Since the SYD method produces the same aggregate depreciation as the straight-line method on any definitions of useful life and salvage value (see Senate Report, pages 27-28), the variations which the Senate Finance Committee thus recognized as existing between the SYD method and the double declining balance method also exist between the latter and the straight-line method.

Any alleged requirement of identity between the aggregate deductions under the straight-line and double declining balance methods is not met by using the Government's own theories, *unless it happened to be true that the taxpayer held the truck*[6] *for the entire depreciable period as defined by the Government.* If the taxpayer happened to dispose of the truck at any time short of that period, the aggregate deductions at the time of disposal would always be larger under the double declining balance method than under the straight-line method.

Neither Senator Millikin nor any other senator or representative speaking on the proposed 1954 Code in committee or on the floor ever indicated that what a depreciable asset brought in the market when sold was any part of recovery. Indeed, the Commissioner's last regulations under the 1939 Code described depreciation as "excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence" (Reg. 118, Sec. 39.23 (l)-1), and the present regulations repeat the formula that the depreciation allowance "shall not reflect amounts representing a mere reduction in market value" (Reg. Sec. 1.167(a)-1(a)).[7]

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[6] The Government concedes that the taxpayer's trucks are eligible for double declining balance depreciation even on the Government's theory of useful life.

[7] The cases have made it clear that of course the limitation also applies in the converse situation—where there is an actual appreciation in market value. For example, in *Max Eichenberg*, 16 B.T.A. 1368 (1929), the taxpayer owned a depreciable building for seven years, but claimed a depreciation deduction only during the last year. He argued that since he sold the building for more than his original cost, no depreciation was sustained (and that his basis upon sale was

So far as "the total amount of the depreciation" is concerned, Senator Millikin was correct in his statement that it cannot exceed—in any of the new depreciation methods, under the restrictions within which they were made available under the 1954 Code—"the actual cost of the property."

[33-34] The Government's claim that a statement at page 23 of the House Report indicates that the Government's view stands for "true economic usefulness and realistic estimates of useful life, rather than . . . artificial concepts of useful life" simply begs the question. Is it the Government's view of useful life which is artificial, or the taxpayer's? The physical business life of depreciable property is a reasonably objective matter, whereas the holding period of assets such as the taxpayer's automobiles was subject to many contingencies, "None of [which] was predictable in advance" (R. 107-108), as the Government itself admits (Brief for the United States, page 5).

(Footnote 7 continued)

therefore virtually unimpaired). This argument was rejected (16 B.T.A. at 1370):

> "[Taxpayer contends] that any physical depreciation of the brick business house was more than compensated by appreciation resulting from increase in the cost of building materials during the term of his ownership. We have heretofore held that for the purpose of computing profit from the sale of depreciable property[,] sustained depreciation may not be offset by appreciation in the market value of the property involved. This issue is controlled by our decisions in *Even Realty Co.*, 1 B.T.A. 355, and *Seton Falls Realty Co.*, 6 B.T.A. 883, which have been fully sustained by the Supreme Court in *United States* v. *Ludey*, 274 U.S. 295."

At page 2 of the Brief for the United States, the Government states the first question presented as being

> ". . . whether the statutory term 'useful life' refers (as the Regulations declare) to the period that an asset is useful in the taxpayer's business, as differentiated from the period (which may or may not correspond) that it is *economically useful.*" (Emphasis added.)

This question is answered (in favor of the taxpayer's position) in the very quotation from page 23 of the House Report cited by the Government at pages 33-34 of its brief, where the House Ways and Means Committee refers to the liberalized depreciation methods as being "more in accord with the actual pattern of *economic usefulness.*" (Emphasis added.)[8]

[34, footnote 14] At pages 53-54 of our opening brief, we pointed out that the depreciation statute, in Paragraph (4) of Subsection 167(b), itself distinguishes between the period of a taxpayer's use of an asset and that asset's "useful life". That provision permits a taxpayer to use any consistent method productive of an annual depreciation allowance

> ". . . which, when added to all allowances for the period commencing with the *taxpayer's use of*

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[8] The same language appears at pages 25-26 of the Senate Report. The penchant of the Government for editing the committee reports to make them conform to its views is illustrated in the Government's position (Brief for the United States, page 36) that "economically useful" really means "economically useful to the taxpayer." The last three words are inserted by the Government; they are not to be found in the committee reports.

> *the property* . . . does not, during the first two-thirds of *the useful life of the property,* exceed . . . [the total depreciation permitted under the double declining balance method]". (Emphasis added.)

Thus, Congress put in juxtaposition, in a single sentence, a reference to "the period commencing with the taxpayer's use" and a reference to "useful life", although, if Congress had intended no distinction between the concepts of a taxpayer's use period and useful life, it would have been easier and simpler to refer instead to a depreciation allowance ". . . which, when added to all allowances for the period commencing with the taxpayer's use of the property . . . does not, during the first two-thirds of *such period,* exceed . . ." or similar wording.

The Government brushed lightly over the foregoing by referring to the words of the statute as "inconclusive phraseology". As the Government well knows, every word in a statute is to be given effect, and distinctions made by the legislative body itself in the wording of a statute are to be given great weight. Surely this is doubly true when it is remembered that the phrase "useful life" had never before appeared in any depreciation statute.

Under such significant circumstances, the juxtaposition of those two concepts in the basic statute imposes a burden of explanation upon the Government which is hardly met by merely designating the language as "inconclusive".

[34-35] The Government's rejoinder to our quotation of Senator Bennett's statement at the Senate Finance Committee hearings (Brief for the Petitioner, pages 59-60) simply mixes up the two examples which he actually put.

The Senator was contrasting two things: first, the result if a man sells machinery *before* he has exhausted its *actual life,* which is that he pays tax on the difference between the machinery's depreciated cost and its sale price; and, second, the result if he depreciates the property "all the way," which is that he "pays tax on the sale price." As pointed out at page 59 of our opening brief, the latter result is impossible under the Government's new views of useful life and salvage value, for Senator Bennett's statement is in keeping only with the taxpayer's position that holding period and full "actual life" are two different concepts.

What the Government has done, in short, is to say, in effect (Brief for the United States, pages 34-35), that if the taxpayer holds an asset for a period less than its physical business life (Senator Bennett's first example), the taxpayer does not hold it for the full physical business life (Senator Bennett's second example).

[35, footnote 15] The Government's response to the Senate floor discussion among Senators Douglas, Daniel, Millikin and Frear (Brief for the Petitioner,

pages 61, 115-119) fails to face up to this fact: The entire colloquy clearly proceeded on the basis that useful life for depreciation purposes means the inherent business life of a property, and not a taxpayer's holding period.

[48-49] The substance of the Government's rejoinder to Recommendation No. 20 on H.R. 8300 filed by the American Institute of Accountants' Committee on Federal Taxation (referred to at pages 82-83 of our opening brief) is that the recommendation "does not even purport to discuss the question whether salvage value constitutes a limitation upon the total depreciation allowable." What could be clearer than the Committee's reference to "the *elimination* of the factor of salvage value in the computation of the declining-balance method"? The Committee did not refer to partial elimination, or elimination during a certain portion of the useful life of an asset, or elimination until depreciation deductions reach a certain figure; the Committee referred simply to "elimination." The Government persists in reading key parts of the legislative history of Section 167 not as they are written but as the Government wishes they were written.

(4) The Government has failed to explain away the Congressional committees' declared intention that in the declining balance method there is no superimposed salvage stop because "at the expiration of useful life there remains an undepreciated balance which represents salvage value."[9]

The Government commences with the proposition (Brief for the United States, page 42) that the above-quoted language (which appears in both the House and Senate Reports) ". . . is a recognition of the fact that when the declining balance method is used there is always some theoretical salvage value left."

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[9] The Government's assertion that the decisions make it clear that salvage value, for depreciation purposes, means more than junk value (Brief for the United States, page 40) may be disposed of briefly.

Commenting on *W. Horace Williams Company, Inc.*, 56-2 USTC Para. 9839 (D.C.E.D. La., 1956), affirmed without discussion of this point, 245 F. 2d 559 (5th Cir. 1957), the Commissioner's Ninth Circuit Brief for the Respondent in *Evans*, No. 143, this Term, stated:

> "In that case the salvage value of a particular asset [the barge *Cap*, a converted LST], in 1948 and 1949, was $50,000. In 1950, the tax year in question, the salvage value fluctuated from zero to $30,000. The court found that an estimated value of $30,000 was fair and reasonable and the depreciation allowance for 1950 was adjusted accordingly." (Pages 46-47, footnote 27, Commissioner's brief.)

But the court's Finding of Fact No. 29 in that case reads, *in full*:

> "The salvage value of the Barge *Cap* at various times during 1950 ranged from zero to $30,000, *fluctuating with the price of and demand for scrap*." (Emphasis added.)

The argument for the United States on this point in *Williams* (defendant's brief, page 14) was the following:

The word "theoretical," of course, is the Government's, not the committees'. The committees stated, without qualification, that the undepreciated balance "represents"—*i.e.*, is the equivalent of[10]—salvage value. Indeed, Congress was not only satisfied to have this undepreciated balance fulfill the function of salvage value for the double declining balance method, but Congress specifically provided, in Section 167(e), for an optional switch to the straight-line method from the declining balance method when the undepreciated balance under the latter is deemed relatively high—as described at page 27 of the Senate Report and as recognized by the Government at page 42, footnote 21 of its brief. Congress provided *no* requirement of a rolling back of depreciation in the converse situation—that is, where the undepreciated balance under the declining balance method is deemed relatively low. In short, Congress was satisfied with the result inherent in the "undepreciated balance which represents salvage value" in the declining balance method.

(Footnote 9 continued)

"The Commissioner's investigation determined upon inquiry from several sources that when LST's were sold by the Government the set price for *scrapping* was between $35,000 and $40,000. We believe that the evidence will show that the present *scrap value* of an LST would be between $30,000 and $50,000, dependent on the condition of the boat, location of the boat, machinery on the boat, and other factors relating to value. The defendants contend that the salvage value of $30,000 assigned to the barge by the Commissioner was fair and it should be affirmed." (Emphasis added.)

[10] The applicable definition of "represent" in *Webster's New International Dictionary of the English Language*, Second Edition, Unabridged (Merriam-Webster, G. & C. Merriam Company, Springfield, Massachusetts, 1951) is "To stand in the place of; to be the equivalent of; as, let x *represent* the momentum."

The issue here is *not*, as the Government misconceives it at pages 38 and 49 of its brief, whether assets "may be depreciated below a reasonable salvage value."[11] The issue is: What *is* salvage value in the declining balance method? The Senate Finance Committee (Senate Report, page 201) and the House Ways and Means Committee (House Report, page A48) make it plain that it is the residual inherent in the operation of the method. No other conclusion can be squared with the Senate Finance Committee's reiteration at two places in the Senate Report (pages 29 and 202-203) that, absent the three-year limita-

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[11] A variant of this argument is the Government's assertion (Brief for the United States, page 43) that "It does not follow . . . that if it is predictable that at the termination of the taxpayer's holding period the actual salvage value will be higher than the theoretical one, taxpayer may ignore the predictable or known factors and depreciate the asset beyond the point where he has recovered his costs." That this is a progression from an erroneous assumption to an equally erroneous conclusion appears from the following:

(a) The record evidence (R. 42, 46) and the District Court's finding (R. 108) are that *none* of the factors influencing the taxpayer's holding period of automobiles was predictable in advance. This the Government fully admits (Brief for the United States, page 5).

(b) In its opening brief to the Court of Appeals below (pages 28-29, footnote 9) the Government further admitted that the amount of recovery on resale is "purely conjectural . . . based as it necessarily is upon the saleability of the asset, the conditions of the particular business and business conditions in general."

(c) As indicated at page 93 of our opening brief and at page 29 herein, there is no "recovery beyond cost" in the declining balance method contended for by the taxpayer. The Government itself pointed out in its Third Circuit brief below (pages 28-29, footnote 9), that recovery through resale is not recovery through depreciation.

tion, the double declining balance method would result in *expensing the cost* (*not* the cost less salvage) of an asset with a two-year useful life in the first year.

As we pointed out in our opening brief, this result could not be so if the Committee were contemplating that salvage value should represent a limitation upon depreciation under the declining balance method. The Government's attempted explanation, at page 45, footnote 24 of its brief, that "expensing the cost" really means deducting all depreciation in one year, whether limited by salvage value or not, runs afoul of the Finance Committee's careful reiteration, in its technical discussion of the bill, that

> "Under the declining balance method an asset with a 2-year life and thus a 50 percent straight-line rate would be *charged off 100 percent in the first year* if the [3-year limitation] did not apply." (Senate Report, page 203; emphasis added.)

As the Senate Finance Committee pointed out (Senate Report, page 201), both the straight-line method and the sum of the years-digits method begin the depreciation process by applying a given percentage to the cost of the property *reduced by salvage value.* But the Committee makes it clear (and the Government agrees) that the declining balance method begins the depreciation process by applying a given percentage to the cost of the property *not reduced by salvage value.* The Government says (Brief for the United States, page 44, footnote 23):

> "It seems unlikely to suppose with taxpayer that the Committee intended in the case of the declining balance method alone that an asset should be depreciated below reasonable salvage value."

As we have indicated above, this "supposition" misconceives the issue. It is obvious that the Committee—and Congress—did not without reason single out the declining balance method as the one method in which (contrary to the procedure in the other methods) depreciation was to start out on a base undiminished by a reduction for salvage value. The Committee—and Congress—had a reason. It was that the salvage value factor was taken into account in another way, for the operation of the declining balance method left an automatic residual—"an undepreciated balance which represents salvage value."[12]

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[12] The Government attempts (Brief for the United States, pages 46-48) to explain away the undeniable fact that in Form 2106—issued as a return form (not merely a worksheet) for claiming, among other things, automobile depreciation—the Treasury has been telling taxpayers: "If declining balance method of depreciation is used, disregard salvage value in computing depreciation."

The Government seeks to assure the Court that this "represents nothing inconsistent with the Commissioner's position" in the case at bar, and that the direction to taxpayers to "disregard salvage value" does not mean in *all* respects. What the direction does not mean is now being explained by the Government for the first time. We are now told that when the Treasury says "disregard", it means *not* to disregard in certain respects not stated, and, that, anyhow, after several years of use, the Form was revised in November, 1958 by eliminating that direction to taxpayers.

It would appear that for a substantial period of time there were persons in authority in the Internal Revenue Service who believed, with this taxpayer and with the Senate and House Committees in their reports on the 1954 Code, that the undepreciated balance represents salvage value, and that, therefore, in computing depreciation under the declining balance method, salvage value is to be disregarded.

(5) The Government's "full recovery of cost" theory is an attempt to divert attention from the Government's real objective—to constrict the depreciation deduction and thus eliminate or severely limit capital gains on sale of depreciable property.

Oddly enough, the Government's contention in this litigation has taken another form almost opposite to its principal argument that a taxpayer must not be allowed to "recover" more than his cost. This anomalous contention appears to be that a taxpayer must recover *not less than* his full cost.[13]

The Government's arguments in favor of its current theories of useful life and salvage value thus are arguments of policy which reduce to these conflicting contentions: First, the Government objects that if the depreciation deduction is computed upon the basis of the property's actual life—a period longer than the period during which it may happen to be used by a particular taxpayer—he *cannot recover the property's cost* (Brief for the United States, pages 21, 23), but, inconsistently, the Government objects that under the taxpayer's position herein *the taxpayer recovers more than his cost* (Brief for the United States, pages 38-39).

These two theories are not only in conflict. They are both wrong.

Initially, the consistent refusal in past years by the Commissioner (and the courts) to limit (or to permit tax-

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[13] Thus the Brief for the United States refers to an alleged "objective of full recovery of cost," and claims that "full recovery is the true objective of the depreciation deductions . . . " (page 21).

payers to limit) "useful life" solely to the partial life of an asset in the hands of the first user makes the Government's present position untenable and its apparent solicitude over the fact that a taxpayer may not recover his cost during his holding period extremely unconvincing.

Moreover, the Government's reverse position—"recovery" of more than cost—simply represents a deceptive misuse of the word "recovery," for the taxpayer's use of the declining balance method cannot, as demonstrated at pages 35-37, *infra,* produce depreciation deductions in excess of cost. And as the Government admitted in the Third Circuit below, recovery through resale is *not* recovery through depreciation. (Brief for the Appellant, page 25, footnote 6.)

This line of argument is, of course, merely another attempt at defeating capital gains which may arise on the sale of depreciable business property.

Dropping its traditional argument that a taxpayer must not depreciate too rapidly, the Government now—sometimes—says that the taxpayer must not depreciate too slowly, and the Government now complains that the taxpayer is not fully depreciating the asset.

But this Court has already answered that complaint. In *Virginian Hotel Corp. v. Helvering,* 319 U.S. 523, 528 (1943), this Court stated:

> "Congress has provided for deductions of annual amounts of depreciation which, along with salvage value, will replace the original investment of the property at the time of its retirement. . . . The rule which has been fashioned by the court below deprives the

taxpayer of no portion of that deduction. *Under that rule taxpayers often will not recover their investment tax-free. But Congress has made no such guarantee.*" (Emphasis added.)

And the Government itself has of course taken the same position in other depreciation litigation. Thus, in *Northern Natural Gas Company* v. *O'Malley*, 174 F. Supp. 176 (D.C. Neb. 1959), now on appeal to the Eighth Circuit—an income tax refund case involving the depreciation allowance—the Government bluntly contradicts the purported principle of mandatory full recovery of cost asserted in the case at bar by stating (Civil Nos. 49-55, 50-55, Government's brief, page 34):

> "Contrary to the bold assertion of taxpayer (Br. 29-30), Congress has given no guarantee that a taxpayer, through annual deductions from income, may eventually recover the entire cost of his investment in every instance and at all events."

Obviously, the formula: depreciation plus salvage value equals cost, is a method of specifying the allowable *rate* of depreciation, and not a mandatory direction that the taxpayer must in all events recover tax-free a certain number of *dollars* through the depreciation deduction.

(6) The Government's historical survey of the phrase "in the business" in the 1918-1942 depreciation regulations does not sustain its position.

The Brief for the United States appears to be trying to urge the importance of the phrase "useful life of the property in the business" appearing in *United States* v.

Ludey, 274 U.S. 295, 301 (1927)[14] (brief, page 20), while at the same time denying the significance of the deletion of that phrase from the Treasury's regulations in 1942 (brief, pages 21-22, footnote 9).

The Government's confusion on this score clearly appears from the following:

(a) The phrase "useful life of the property in the business" (which appeared in the depreciation regulations from 1918 to 1942) did not appear in the 1942-and-following regulations, which, instead, referred to "useful life of the depreciable property" (Regulations 111, Sec. 29.23(l)-1). The term "in the business" as it appeared in the regulations from 1918 to 1942, had the sole purpose of defining the nature or type of assets which could be depreciated by a taxpayer, that is, property devoted to business, or, simply, business property. It is clear that the term did not mean and never was intended to be a limitation on the period during which business assets could be depreciated.

The Ninth Circuit in *Evans* v. *Commissioner of Internal Revenue*, 264 F. 2d 502 (9th Cir. 1959), No.

[14] The Government's attempt to elevate *Ludey's* statement to something more than *dictum* (Brief for the United States, page 21, footnote 8) flies in the face of the following facts: The Court found (274 U.S. at 297) that "The finding of the depreciation was, likewise, in accordance with the method of computation employed by the Bureau; and there was no objection to the method of computation." And the remandment, so far as depreciation was concerned, was solely for the purpose of allocating depreciation deductions over "several properties purchased at different times" (274 U.S. at 304), which an inadequate record had not permitted the Court to do. There was, in short, no dispute over the principles or methods of depreciation.

143, this Term, properly assessed the language change in the regulations when it stated (264 F. 2d at 508):

> "The significance, if any, to be attached to the omission of the words 'in the business' from Regulations 111 is obscure. We attach no significance thereto because in our view the practice and position of the Commissioner has been the same under Regulations 45 and succeeding regulations up to T.D. 6182 [the depreciation regulations issued in June, 1956], except for a few recent cases under Regulations 111 of the Internal Revenue Code of 1939, in which the Commissioner asserted the concepts of 'useful life' and 'salvage value' embodied in T.D. 6182.
>
> "From the practice of the Commissioner over the years, it appears to us that the phrase 'in the business' included in earlier regulations simply defined the type of assets which were subject to the depreciation allowance. The omission of such phrase from Treasury Regulations 111 would not furnish the basis for an interpretation of the term 'useful life' which it did not have when the phrase appeared in the regulations."

(c) The Commissioner argues in *Evans*, No. 143, this Term (Brief for the Petitioner, page 22, footnote 14): "In view of the fact that a specific detailed definition of depreciable property was contained in Section 19.23(l)-2 [of Regulations 103, effective for 1939-41], the use of the words 'in the business' in Section 19.23(l)-1 undoubtedly was intended to have a function other than that of mere definition. And this function, we submit, was to limit the concept of 'useful life' to that time dur-

ing which the property was useful 'in the business' of the taxpayer."

The Commissioner's inference appears totally unjustified, however, when it is realized that Regulations 111, applicable to the years 1942-1951, contained the following provision:

> "The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under section 29.23 (a)-15 as held by the taxpayer for the production of income." (Reg. 111, Sec. 29.23(l)-2, in part.)

The entire portion of this sentence beginning with "or treated" was added by T.D. 5196, 1942-2 CB 96, 100, after Section 121(c) of the Revenue Act of 1942 (56 Stat. 798, 819) added "property held for the production of income" to the items on which depreciation could be deducted.

That "used . . . in the business" and "held . . . for the production of income" were simply parallel definitions of the two basic types of assets depreciable after the 1942 statutory amendment is borne out by the following: If "used in the . . . business" meant, as the Government now contends, a measure of *time*, then when "held . . . for the production of income" was added, it would have been necessary to *retain* (for the first type of asset) the phrase "in the business." The Treasury could—and did—eliminate that phrase because the phrase was merely another (and now unnecessary) phrase descriptive of the *kind* of assets (*i.e.*, assets used in the trade) which were depreciable.

In the pre-1942 regulations (and in *Ludey*) "in the business" was the generic phrase used to describe the

kind of property which could be depreciated, just as "useful life of the depreciable property" in the 1942-and-following regulations merely enlarged the generic class of such property, as required by the 1942 change in the statute.

"In the business" did not have the function of limiting the definition of useful life to a taxpayer's period of use, as lately claimed by the Government.

(7) The Government's arithmetical examples illustrate the error of its view.

(a) At pages 21-22 of our opening brief, we gave the example of two taxpayers who are in the same type of business and who buy—at the same time and at the same price—an identical asset, but who estimate their respective holding periods differently. We showed how the Government's new views of useful life and salvage value provided *different rates* of depreciation on assets which were undergoing the *same rates* of "exhaustion, wear and tear."[15]

At pages 24-25 of its brief, the Government seeks to neutralize this example by showing an alleged effect "If we were to adopt the hypothesis advanced by the taxpayer. . . ." But the Government's example shows only a confusion of concepts, for it conveniently takes the useful

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[15] The Government edited our statement, at page 24 of its brief, by neglecting to indicate that we were referring to the *rate* of "exhaustion, wear and tear." Those are *physical facts*. Obviously, the aggregate *physical* usage of an asset used for four years will be greater than the *physical* usage of the same asset used for the same purposes for only two years—but why should the *rate* be different for these two taxpayers? It is different, under the Government's current concepts of useful life and salvage.

life definition which the taxpayer contends is correct and then *fails* to take a salvage value determined at the end of *that* useful life. The Government takes, instead, a salvage value (for each taxpayer) estimated on the basis of the *Government's* theory and superimposes it upon the petitioner's view of "useful life." But salvage value is the reciprocal of useful life, and this combination of disparate concepts in the Government's brief serves only to confuse the issue.

(b) Equally defective is the Government's example of Automobile No. 239 (Brief for the United States, page 38, footnote 18).[16] It is as fallacious and irrelevant as the Commissioner's example in *Evans,* No. 143, this Term (Brief for the Petitioner, page 28, footnote 16; see Brief for the Respondents in *Evans,* pages 57-59).

The Government's example seeks to make a point by constructing a "recovery" through sales (at what the market happens to bring) and then injecting this "recovery" into a statutory standard which grants a deduction for "exhaustion, wear and tear," *not* reduction in market value. It simply confuses realization through sales value—at current market price whenever sold—with "recovery" through depreciation deductions.

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[16] Contrary to the District Court's acceptance of the Government's assertion (R. 119), this example was not taken "at random." Thus, in addition to its other deficiencies, discussed *infra,* this example reflects a sales price for an automobile which is *twice* the average $800 sales price received by the taxpayer on sales of its automobiles during the taxable years under review (R. 13-18), and a holding period for an automobile which is about *one-half* of the taxpayer's average holding period during those years (R. 104, 108).